

**GAINS DERIVED FROM ILLEGAL ACTIVITIES:
AN ANALYSIS OF THE TAXATION
CONSEQUENCES**

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ABSTRACT

Income Tax in South Africa is levied in terms of the Income Tax Act 58 of 1962 on taxable income, which, by definition, is arrived at by deducting from "gross income" receipts and accruals that are exempt from tax as well as deductions and allowances provided for in the Act. The Income Tax Act provides no guidance with regard to the taxation of illegal activities, except to prohibit the deduction of expenditure incurred in paying fines or in relation to corrupt activities, as defined. An analysis of the taxation of income derived from theft, fraud and prostitution and the deductibility of expenses relating to that income, is the question addressed in this thesis. In this thesis, an analysis was made of relevant case law in relation to the provisions of the Income Tax Act in an attempt to provide clarity. A brief comparison was also made of American, United Kingdom and South African tax law. Similarities were found between the American, United Kingdom and South African tax regimes in relation to the taxation of income; but there appeared to be more certainty in America and the United Kingdom in relation to the deduction of expenses. The thesis concludes that recent case decisions have provided certainty in relation to income from illegal activities, but the tax status of the deduction of expenses remains uncertain.

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CHAPTER 1: INTRODUCTION

1.1 CONTEXT

By taxing proceeds from illegal activities the State would be keeping its revenue eye open and its eye of justice closed¹. The Sunday Times² reported that the United Nations recognises a world-wide growth of the shadow economy which includes the trade in stolen goods, illegal drug manufacturing, prostitution, gambling, fraud, etc. As this shadow economy grows the question is whether or not profits from this economy are taxable.

The South African Revenue Services (to be referred to as SARS) is entrusted with a duty to collect taxes and to do so it is guided by the Income Tax Act³ (hereinafter referred to as “the Income Tax Act”). The taxing statute targets a wide range of activities, without having regard to the legality of the activity that gave rise to income. A question to be asked at this point is whether or not the State should refrain from taxing illegal activities because to tax would amount to legitimising the illegitimate⁴. Taxing income from illegal activities invites a debate concerning whether the taxpayer should be entitled to a deduction of any expenditure incurred in producing income from illegal activities. If delinquent taxpayers are not taxed, the question of equal treatment of taxpayers arises and if they are not allowed deductions the same question arises. It has been argued that by taxing such illegal activities SARS is not necessarily condoning them⁵. SARS has not been involved in the commission of the illegal activity; it merely recognises income derived from what appears to be a trade, and the Revenue laws provide for the taxation of income from trades⁶. There is an argument, where income received illegally is concerned, that it

¹ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752

² Shevel 'Huge tax orgy in sex industry' 2006 *Sunday Times* 12 February: 4.

³ *Income Tax Act* 58 of 1962, as amended

⁴ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

⁵ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752

⁶ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752

would be preferable for tax law to stand aloof and attach no tax consequences to the income and let the whole matter be dealt with in terms of criminal law⁷.

This thesis will demonstrate that income from illegal activities is subject to tax, but there is some doubt whether expenses incurred in generating that income would be deductible. An open question is whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their illegal income. Revenue laws should tax the economic gain derived by the taxpayer by allowing the taxpayer to reduce his or her taxable income by the cost of earning the income⁸. Thus, if tax law is looked at in isolation, the ideal outcome would be to include the proceeds from illegal activities in the gross income, while the allowing the perpetrator to claim the deductions to which he or she would have been entitled, had he or she been an 'honest' trader⁹. A legal system is made up of a body of laws that deal with different issues but at the same time they all have the same purpose. The rationale behind the denial of deductions is that government should not allow wrongdoers to benefit from their misdeeds through the tax law¹⁰. However, tax law is designed to collect revenue and criminal law is designed to punish wrongdoers. Tax law should therefore be neutral and provide for the taxation of the income and the deduction of expenditure incurred in earning such income. Being neutral entails taxing income if it meets the requirements of income and allowing a deduction if it meets the requirements of a deduction.

Deductions may be disallowed on the basis that the taxpayer was involved in disapproved activities¹¹. Tax is not levied on gross income but on the taxable income of the taxpayer, after the deduction of qualifying expenditure. Disallowing expenditure incurred in the

⁷ PricewaterhouseCoopers 'The taxability of illegal pyramid schemes' 2007 Synopsis at 2-3

⁸ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 274

⁹ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

¹⁰ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 275

¹¹ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 277

production of income would mean that, for some taxpayers, tax is levied on their gross income. The denial of deductions is not consistent with the idea of taxing income after deductions because, if deductions are disallowed then gross income will be taxed¹². By refusing deductions, tax law is punishing people for disapproved activities by denying the benefits that would be available for inoffensive business expenses¹³. In a legal system there are many branches of law that discourage certain behaviour, but tax law is designed to be a neutral body of financial rules for revenue collection and, other than revenue crimes, tax law leaves punishment for bad behaviour to other branches of law¹⁴. Denial of deductions punishes taxpayers for non-revenue crimes and this is inconsistent with a neutral structure¹⁵. The main objective of tax law is to collect revenue by taxing a taxpayer's net income, not to reform his or her character, so that tax law should not be used to punish taxpayers for their non-revenue crimes. Bootle J, in *Dixie Machine Welding*¹⁶ held that tax law should take taxpayers as they are by taxing them and leaving their punishment to other branches of law that are tasked and trained to punish, and also that tax law should not be used to extirpate evil or for the espousal of public policy. DeMattei¹⁷ argues that the motive for involvement in illegal activities is the profit so derived, thus if the profit is taxed, it decreases the lucrative nature of such activities. The role of taxation in such cases would be to deprive organised crime of substantial amounts of money.

Refusing certain taxpayers the deduction of expenditure incurred in the production of their income leads to a differing treatment of taxpayers in that certain taxpayers are taxed on their taxable income (after deducting qualifying expenses), while those deriving their

¹² Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 277

¹³ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 278

¹⁴ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 280

¹⁵ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 280

¹⁶ *Dixie Machine Welding and Metal Works, Inc v United States* 315 F.2d 439 (5th Cir. 1963)

¹⁷ DeMattei "The Use of Taxation to Control Organized Crime"(1951) *California Law Review* 39 (2): 226-234

income from illegal activities are taxed on their gross income. This treatment is inequitable and unreasonable¹⁸.

Ordering the restoration of the status *quo*, while denying the deduction of the cost of restoration, appears to amount to a form of double taxation. It is the principle of our law that a person cannot be convicted twice for the same offence. Section 35(3)(m) of the Constitution states that every accused person has a right not to be tried for an offence in respect of an act for which that person has previously been either acquitted or convicted. When the accused is required to plead he or she may plead that he has already been convicted of the offence with which he is charged, in terms of section 106(1) of the Criminal Procedure Act. In *McIntyer v Pietersen*¹⁹ it was held that this right protects an individual from being repeatedly prosecuted for the same conduct or offence. Tax law seeks to tax a taxpayer on his or her taxable income (gross income, less exempt income, less deductions) and if deductions are not granted this can be regarded as a penalty. If the accused is criminally prosecuted as a result of disclosure of income for income tax purposes or when a civil claim is brought against him or her to restore the status *quo*, it is submitted that this would amount to punishing the accused twice.

The question of double taxation may therefore arise where the criminal is taxed on his or her income from illegal activities, but denied the deduction of expenses and losses incurred in deriving the income. The rule of law provides that laws must be certain and individuals are entitled to know their rights and obligations in advance with certainty²⁰. The Constitution provides for the separation of powers between the executive, legislature and the judiciary. All three arms have different mandates and SARS forms part of the executive branch of government and is mandated with applying the laws made by the

¹⁸ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 274

¹⁹ *McIntyer v Pietersen* 1998 (1) BCLR 18 (T).

²⁰ Bodlani "SA's tax laws inconsistent with the rule of law" Available: <http://www.moneyweb.co.za/mw/view/mw/en/page38?oid=62036&sn=Detail> [Accessed 20/06/2007].

legislature. SARS should not be in a position to decide that tax is due where this is not unambiguously stated in law²¹.

Another problem that may arise, should the income from illegal activities be taxed, is the rights of the victim, if the perpetrator should become insolvent. When a person is declared insolvent his estate is wound up and creditors are paid. Before creditor's claims can be satisfied, the free residue is first used to pay or satisfy the claims of preference creditors, which are funeral expenses, death bed expenses, costs of sequestration, costs of execution, salaries for employees of the insolvent and income tax²². After all these expenses are paid creditors are then paid according to their rank, secured creditors being at the top of the list and then concurrent creditors. Secured creditors are creditors who hold security for their claims and concurrent creditors on the other hand do not hold security for their claims and are entitled to be paid after all the claims of secured creditors have been satisfied²³. For Income Tax purposes, section 101 of the Insolvency Act provides that the free residue shall be applied to the payment of any tax for which the insolvent was liable under any Act of Parliament in respect of any period prior to the date of sequestration of the insolvent's estate.

In terms of the law of insolvency the Revenue Services are therefore one of the preferential creditors and even rank above secured creditors. This means that a holder of a judgement against the insolvent will only be paid his or her claim after the preferential creditors have been satisfied. It can be questioned whether it is fair to levy tax in the hands of the thief in cases of insolvency, as there is little or no property for the effective grant in favour of the victim of the crime, of a spoliation order or the order granted in terms of section 300 of the Criminal Procedure Act. Under section 300 of the Criminal Procedure Act, if there is no property to compensate, the judgement creditor has no other remedy as they would not be able to enforce a judgement against a judgement debtor with no funds

²¹ Bodlani "SA's tax laws inconsistent with the rule of law" Available: <http://www.moneyweb.co.za/mw/view/mw/en/page38?oid=62036&sn=Detail> [Accessed 20/06/2007].

²² Insolvency Act 24 of 1936, s 96-104.

²³ Sharrock, van der Linde and Smith *Hockly's Insolvency Law* 8 ed (2006) 168.

or property. This means that if thieves or persons committing fraud are taxed the *fiscus* always benefits and the victim is not guaranteed a remedy. Our law appears to tax the thief in these circumstances and enrich the *fiscus* at the expense of the victim.

The revenue laws seek to tax even at the expense of the victim of crime and this makes remedies like a spoliation order and the remedy under section 300 of the Criminal Procedure Act incompetent to cater for the rights of the victims. The purpose of these remedies is to restore the status *quo* and if the perpetrator is indigent or insolvent, the *fiscus* will claim what is due to it and only if there is any property remaining will other creditors and the judgement creditor get to be paid all or part of their claims. The question posed should possibly be: Is it constitutional to tax at the expense of victims?

The Commissioner for the South African Revenue Services is responsible for carrying out the provisions of the Income Tax Act in terms of section 2 and for levying tax on a taxpayer's taxable income as provided for by section 5. South African law as it stands requires the status *quo* to be restored when a spoliation order or a remedy in terms of section 300 of the Criminal Procedure Act is sought. This implies that the defendant or accused will have to refund the whole amount, not taking into account the fact that he or she has paid tax on it. It would appear that the income derived from illegal activities is subject to tax, but there is some doubt whether expenses incurred in producing the income would be deductible in arriving at taxable income. The person engaged in illegal activities would be taxed on income so derived, but may not be entitled to deduct either the expenses incurred or the compensation due to the victim. In effect, therefore, the compensation payable would have been subject to double tax – once when the illegally obtained proceeds are received and then by denying a tax deduction when the compensation is paid.

Income tax, in terms of the Income Tax Act, is imposed on “taxable income” as defined²⁴, which is arrived at as follows:

²⁴ Income Tax Act 58 of 1962, s1

“Gross income”²⁵

Less: Exempt income (sections 10 and 10A of the Income Tax Act)

Equals: Income

Less: Allowable deductions (Part I of Chapter II of the Income Tax Act)

Plus: All amounts included or deemed to be included in the taxable income
of any person in terms of the Income Tax Act

Equals: “Taxable income”

None of the definitions or sections in the Income Tax Act which apply in arriving at the “taxable income” of a person make any reference to the taxability or non-taxability of income derived from illegal activities, except for section 23(o) which specifically prohibits the deduction of “any expenditure incurred where the payment of the expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004; or which constitutes a fine charged or a penalty imposed as a result of an unlawful activity”

As early as 1918, in *CIR v Delagoa Bay Cigarette Co*²⁶, it was held that the legality or illegality of the business which produced the income was irrelevant in relation to the liability for income tax. In *ITC 1199*²⁷, it was held that the tax collector has cast his net wide enough to catch all income so that once a receipt or accrual is held to constitute income it is taxable in terms of the Income Tax Act, irrespective of whether it is legal or illegal income. The victims of certain crimes have the right to recover their property or claim restitution and this may affect the taxability of the illegal income or the timing of the taxation thereof. Nevertheless, the position in relation to *income* arising from illegal activities, provided it complies with all the requirements for inclusion in taxable income, appears to be relatively certain. It is submitted that the position relating to allowable deductions is less certain, as public policy issues may prevent the deduction of expenses

²⁵ Income Tax Act 58 of 1962, s1

²⁶ *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391, 32 SATC 47

²⁷ *ITC 1199* 36 SATC 16 at 19

and other allowances in respect of income from illegal activities (refer to ITC 1490²⁸ - to be discussed in chapter 3). This thesis discusses the taxation of income from illegal activities and specifically amounts received or accrued and deductions claimed in arriving at the taxable income from prostitution, theft and fraud.

Any person who is liable for tax is required to furnish a return upon receiving notice by the Commissioner²⁹, containing such particulars as may be prescribed by the Commissioner. Despite the secrecy provisions contained in the Income Tax Act³⁰, the Commissioner may, under certain circumstances, disclose information to the National Commissioner of the South African Police Service³¹. The Constitution of the Republic of South Africa³² (to be referred to as the Constitution), in section 35(1), stipulates that when persons are arrested they have a right to be informed about their rights and, most importantly, that what they say may be used against them in court and that they will not be forced to make a confession. When taxpayers file tax returns, they are required to disclose fully information about their income. They are not informed that the information they provide may be used against them in court and they are also not assisted by any legal representative when making such disclosure. This aspect of the taxation of income from illegal activities will also be discussed in this thesis.

The thesis also deals briefly with the taxation of income from illegal activities in the United States of America (referred to as the United States) and in the United Kingdom, in order to compare the principles applying in these jurisdictions with the situation in South Africa.

The broad question to be addressed in this research is therefore whether the present basis of dealing with income from illegal activities in terms of the Income Tax Act, is appropriate.

²⁸ *ITC 1490 53 SATC 108*

²⁹ *Income Tax Act 58 of 1962 s66*

³⁰ *Income Tax Act 58 of 1962 s4*

³¹ *Income Tax Act 58 of 1962 s4(1B)*

³² *The Constitution of the Republic of South Africa Act 108 of 1996*

1.2 THE OFFENCES

There are different types of crime: crimes against human life, crimes against family life, crimes against property, crimes against community interests, crimes against sexual morality, crimes against collective welfare, etc³³. Some of these crimes have victims and thus in a crime against property the property owner is the victim. Crimes against collective welfare include such crimes as bribery, corruption, substance abuse and road traffic offences. These crimes do not *per se* have victims. There are also different types of illegal income: certain types of income are derived from activities that are illegal and other types of income are from a legal source, but were derived in an illegal manner. An example of the latter would be a trader carrying on a lawful trade who then commits a crime in deriving part of his or her income for the year.

Fraud is the unlawful making of a misrepresentation with intent to defraud, which causes actual prejudice or which is potentially prejudicial to another³⁴. The intention required to be possessed by the perpetrator for this type of crime is the intention to defraud³⁵. Theft, on the other hand, is an unlawful appropriation with the intent to steal a thing capable of being stolen³⁶. The taking must be done without the owner's consent and the appropriation happens when the thief behaves as if he or she is the owner of such property and deals with it the way an owner would³⁷. The Sexual Offences Act³⁸ provides that it is an offence for any person to have unlawful carnal intercourse, or commit an act of indecency with any other person for a reward. The Sexual Offences Act further prohibits the keeping of brothels, the procurement of females as prostitutes and knowingly living on the earnings of prostitution³⁹.

³³ Burchell and Milton *Principles of Criminal Law* (2004)

³⁴ Burchell and Milton *Principles of Criminal Law* (2004) 833

³⁵ Burchell and Milton *Principles of Criminal Law* (2004) 844

³⁶ Burchell and Milton *Principles of Criminal Law* (2004) 782

³⁷ Burchell and Milton *Principles of Criminal Law* (2004) 787

³⁸ *Sexual Offences Act* No 23 of 1957, s20(1)(aA)

³⁹ *Sexual Offences Act*, s20(1) (a)

1.3 THE OBJECTIVES OF THE STUDY

This research seeks to investigate the tax implications of receipts and accruals, as well as expenses, relating to illegal activities, with a specific focus on fraud, theft and prostitution.

The objectives of this research are

- To analyse the taxability of the receipts and accruals derived from illegal activities, including the timing of a receipt and thus the time of levying taxation, given the remedies available to the victim of the crime.
- To analyse the deductibility of expenses incurred in the production of income from illegal activities.
- To do limited a comparative study of the taxation of income from illegal activities using United Kingdom legislation and legislation of the United States.

1.4 SOURCES OF DATA AND THE RESEARCH APPROACH

A qualitative analysis of documentary sources was carried out in order to investigate the taxation of income from illegal activities.

Reference was made to the Income Tax Act, the Criminal Procedure Act, the Law of Evidence and the Constitution of the Republic of South Africa. The principle of the *mandament van spolie* and the remedy provided for in section 300 of the Criminal Procedure Act are relevant sources of data, as well as court decisions relating to all of the legislation and the writings of authoritative experts in the various areas.

A limited comparative study was also made of South African and United Kingdom legislation and the legislation of the United States of America, as well as court decisions and the writings of experts in these jurisdictions.

1.5 STRUCTURE OF THE THESIS

The thesis has been divided into five chapters. Chapter One serves as an introduction to the thesis. Chapter Two deals with the taxation of income in South Africa and investigates the taxability of income from illegal activities. Chapter Three investigates the deduction of expenditure incurred in the earning of income and particularly expenses incurred in generating income from illegal activities. Chapter Four focuses on a brief comparative study between South Africa, the United States and the United Kingdom of the taxation of income from illegal activities and of expenditure incurred in the production of illegal income. Chapter Five summarises the conclusions reached.

CHAPTER 2: SUBJECTING INCOME FROM ILLEGAL ACTIVITIES TO INCOME TAX IN SOUTH AFRICA – RECEIPTS AND ACCRUALS

2.1 INTRODUCTION

Chapter One described the context in which the research is situated, defined the offences of prostitution, theft and fraud, stated the objectives of the research, discussed the research methodology and briefly outlined the chapters to follow. The present chapter addresses the first research objective: the taxation of income from illegal activities. In doing so, the definition of “gross income”⁴⁰ is discussed in general terms and in relation to income from illegal activities. Because the victims of the crimes of theft and fraud have legal remedies against the criminals, the income from these activities may be contingent pending the reimbursement of the victims. This may have an impact on the taxation of such income. This chapter therefore discusses the remedies available to the victims.

2.2 GROSS INCOME

“Gross income”⁴¹

in relation to any year or period of assessment, means –

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of a person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature . . .

Gross income is the starting point for the levying of tax because, for persons to be taxed, they need to have taxable income on which their tax would be calculated. In other words,

⁴⁰ *Income Tax Act 58 of 1962*, s1

⁴¹ *Income Tax Act*, s1

if a person does not have gross income he or she cannot be liable to pay tax⁴². Receipts or accruals which are capital in nature are excluded from the gross income definition, but the Income Tax Act further provides for certain receipts and accruals, which can be of capital nature, to be included in terms of paragraphs (a) to (n) of the gross income definition. The Income Tax Act does not define the terms used in the gross income definition and the judiciary, as interpreters of the law, have a duty to give meaning to such terms. For the meaning of these terms as used in the Income Tax Act, reliance is placed on the meanings given to such terms by the courts, in cases that come before them. The gross income definition does not provide that a receipt or accrual must have been derived in the course of a legal pursuit in order to be included in a taxpayer's gross income, so this question has been left to the courts to decide⁴³.

The case of *CIR v Delagoa Bay Cigarette Co*⁴⁴ dealt with income flowing from illegal activities. In this case the company was selling packets of cigarettes at an inflated price and placing a numbered coupon in each of these packets. Two-thirds of the selling price was set aside as a prize fund from which a monthly distribution was made. Two such distributions had been made and a third was pending, but criminal proceedings had been instituted on the grounds that the officials of the company were running a lottery. To prevent the payment of the prizes, thereby rendering the company unable to pay the tax, the Commissioner had issued an interim assessment based on the argument that the payment of the prize money was a disposal of profits after they had been earned. The company's counter-argument was that the prizes constituted an expense incurred in the production of income and not a disposal of income after it had been earned, that the business of the company was illegal and that the State could therefore not levy taxes on the profits from illegal transactions. The court held that the payment of the prizes was made in terms of the contract under which the cigarettes were sold and was not a

⁴² Huxham and Haupt *Notes on South African Income Tax* 25th edition (2006) 2.

⁴³ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

⁴⁴ *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391, 32 SATC 47

distribution of income after the cigarettes were sold. The court also held that the Commissioner was not debarred in terms of the Act from demanding payment under an interim assessment to ensure the payment of tax that was due. It was held further that the legality or illegality of the business which produced the income was irrelevant to the liability for income tax. Bristowe, J stated this as follows⁴⁵

I do not think it is material for the purpose of this case whether the business carried on by the company is legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum . . . The source of the income is immaterial. This was so held in *Partridge v Mallandaine* [18 QBD 276] where the profits of a betting business was held to be taxable to income tax; Denman J saying that 'even the fact of a vocation being unlawful could not be set up against the demand for income tax'. If the income itself is taxable, it follows I think that if the prizes had been a legitimate deduction had the business been legal, they would equally be a legitimate deduction if the business is illegal.

In *ITC 1199*⁴⁶, it was held that the tax collector has cast his net wide enough to catch all income so that once a receipt or accrual is held to constitute income it is taxable in terms of the Income Tax Act, irrespective of whether it is legal or illegal income.

It would appear, therefore, that provided a receipt or accrual of income from illegal activities meets all the requirements of the definition of "gross income", it will be included in gross income and will be subject to income tax.

Receipts and accruals from prostitution would include the amounts paid directly to a prostitute for his or her services, the receipts of a brothel-keeper who employs prostitutes to provide services to clients and the receipts of persons acting as "agents" for prostitutes who earn a fee for their procurement services or who live on the earnings of prostitution. The gains of thieves would include either cash or property derived from theft and the perpetrators of fraud would obtain cash or property from their victims.

⁴⁵ Williams, R.C. *Income Tax in South Africa: Cases and materials* 2nd ed. (2005) 168

⁴⁶ *ITC 1199* 36 SATC 16 at 19

To be included in gross income, amounts derived from illegal activities would have to meet all the requirements of the definition. The definition and the related case law are discussed below.

2.2.1 AMOUNT

The gross income definition includes all amounts received by or accrued to the taxpayer. Amounts obtained from illegal activities may also have the quality of income and also satisfy the “received by” principle established in *Geldenhuis v CIR*⁴⁷ that provides that a taxpayer receives money if he or she receives it on his or her own behalf and for his or her own benefit.

The word ‘amount’ in the gross income definition does not only refer to money but also to the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value⁴⁸. In *CIR v Butcher Brothers (Pty) Ltd*⁴⁹ it was held that the word “amount . . . must mean an amount having an ascertainable money value”. If a taxpayer steals property or defrauds a victim of property, the value of such property will be the amount for tax purposes. In *CIR v Delfos*⁵⁰ it was held that if an amount “is something which is not money’s worth or cannot be turned into money, it is not to be regarded as income.” This decision was not followed in the Appellate Division decision in *C:SARS v Brummeria Renaissance (Pty) Ltd and Others*⁵¹ where it was held that “the question whether a receipt or accrual in a form other than money has a money value is the primary question and the question whether such receipt or accrual can be turned into money is but one of the ways in which it can be determined whether or not this is the case”. In barter transactions no money is involved but a taxpayer is taxed on the value of

⁴⁷ *Geldenhuis v CIR* 1947 (3) SA 256 (C) at 260

⁴⁸ *Lategan v CIR* (1926) AD

⁴⁹ *CIR v Butcher Brothers (Pty) Ltd* 1945 AD 301 at 318

⁵⁰ *CIR v Delfos* 1933 AD 242, at 251

⁵¹ *C:SARS v Brummeria Renaissance (Pty) Ltd and Others* 69 SATC 205 at 207

the asset received, if it is not of a capital nature⁵². Where an amount cannot be established, gross income will not arise from that undeterminable amount; Feetham, J.A., in *CIR v Butcher Bros. (Pty) Ltd.*⁵³, stated (*obiter*) that “a consideration must have a money value”. This does not mean that where it is difficult to determine the amount it is non-existent, and therefore not taxable⁵⁴.

Thieves may steal either cash or goods, the perpetrators of fraud may defraud their victims of cash or goods and prostitutes may receive gifts as well as cash for their services. If the goods fall within the other requirements of “gross income” they would be taxable and the “amount” would have to be determined.

2.2.2 RECEIVED

All amounts received by a taxpayer are included in “gross income”, provided they comply with all the other requirements of the definition. Not all obtaining of physical control of money, however, amounts to a receipt. *Geldenhuis v CIR*⁵⁵ (heard in the Cape provincial division of the Supreme Court) concerned a usufruct created in terms of a massed will over a flock of sheep. After farming with the sheep for a number of years during which a number of sheep were sold, a number died due to drought and the numbers were never restored to the original number on the date of death of the testator, the flock was sold with the consent of the “remaindermen” and the proceeds deposited in the bank account of the usufructuary. The question before the court was whether the difference between the proceeds and the original value of the flock at the date of death was taxable in the hands of the usufructuary, the proceeds having been “received” by her in terms of the definition of “gross income”. Furthermore, the question arose whether the provisions of the Act relating to the taxation of pastoral, agricultural or other farming operations (in terms of

⁵² Silke *Silke on South African Income Tax* volume 1 (2003)18-27

⁵³ *CIR v Butcher Bros. (Pty) Ltd.* 1945 AD 301, 13 SATC 21

⁵⁴ Huxham and Haupt *Notes on South African Income Tax* 25th ed (2006) 10

⁵⁵ *Geldenhuis v CIR* 14 SATC 419

section 14 of the Income Tax Act 39 of 1945) created a new definition of “taxable income”.

Steyn, J stated as follows (at 431):

Both “income” and “taxable income” are in their respective definitions linked up with the definition of “gross income” and it seems to be clear that in the definition of “gross income” the words “received by or accrued to or in favour of any person” relate to the taxpayer, and the words “received by” must mean “received by the taxpayer on his own behalf and for his own benefit”.

In *SIR v Smant*⁵⁶ the taxpayer divested himself of his right to receive amounts in connection with shares in a company. The court held that the continued payment of dividends to him did not give him a right to them, that he was obliged to repay it when he received it and thus such receipts were not for his own benefit.

For thieves and the perpetrators of fraud, the sole reason for their actions is to benefit themselves and, indeed, they do apply the amounts they take from their victims for their own benefit.

2.2.2.1 “RECEIVED” IN RELATION TO FRAUD

Fraudulent schemes may take on many forms and one such form that was frequently the subject of court decisions is one where the perpetrator of the fraud enriches himself or herself out of moneys entrusted to him or her by others. *ITC 1624*⁵⁷ dealt with a case where a member of a close corporation, which paid wharfage fees on behalf of a client, fraudulently recovered amounts in excess of the amounts paid out on behalf of the client, misappropriating the amounts. The close corporation’s financial statements for the year in question disclosed an amount of R200 814 as part of the “fees and disbursements

⁵⁶ *SIR v Smant* 1973 (1) SA 754 (D) at 764

⁵⁷ *ITC 1624* (1997) 59 SATC 373

recovered” and also as “less disbursements and fees”. The close corporation (the appellant) maintained that the disputed amount formed part of “accounts payable”, while the Commissioner for Inland Revenue contended that it was a provision in respect of the client’s claim and therefore not deductible. In his appeal to the Commissioner in relation to the question of the receipt of the amount fraudulently recovered, the accounting officer of the appellant relied on the decision in *CIR v Genn & Co (Pty) Ltd* 20 SATC 113 stating that the monies were received on behalf of various principals of the close corporation as the ultimate beneficiaries under circumstances where a loan obligation was imposed to repay such monies to its Principal and that the receipt of the monies is therefore in the nature of a capital receipt. The case presented to the Court for the appellant, however, was that the disputed sum had not been received by the appellant so as to constitute “gross income” as it had not been received “on its own behalf and for its own benefit” and “it had not received it in such circumstances as to become entitled to it”, citing *Geldenhuis v CIR*, *CIR v Genn & Co (Pty) Ltd*, *CIR v Smant*, *COT v G* 43 SATC 159 and other cases. It was also contended that the close corporation was entitled to claim a deduction of the same amount as it had received as expenditure incurred in the production of income in terms of section 11(a) of the Act (to be discussed in paragraph 3.2.3).

It was held (*inter alia*):

- (i) That where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business.
- (ii) That if the money is paid to an agent, in the broad sense, for the purpose of being paid by him to another for the payer’s benefit, so that the agent is in essence a conduit or trustee, the effect of the contract is that the money has not been received by the agent for his own benefit and it has also not been received as a reward or remuneration for services rendered and that applies to moneys legitimately recovered by the appellant from its customer A for disbursements made to others. [own emphasis]
- (iii) That if a dishonest attorney recovered from his or her client a sum for a witness fee and corruptly negotiated with the witness to accept a lesser sum than he or she had charged, so that

he or she could retain the balance, it could surely not be suggested that the attorney had not received, in the tax sense, the overcharged amount and the same would apply to the disputed sum obtained by the appellant in the case by overreaching [sic] its client.

The appeal was therefore dismissed.

*ITC 1792*⁵⁸ concerned a stockbroker who was a member of a stock-broking firm on the Johannesburg Securities Exchange, buying and selling securities on behalf of clients for their benefit – thus acting as an agent pursuant to a mandate given to him by clients. He had become involved in a syndicate with dealers or portfolio managers acting on behalf of a client. The syndicate purchased shares, which it generally knew the client intended to purchase and sold the shares at a profit to the client. The stockbroker's share of these illegal profits was the subject of an appeal against the Commissioner for SARS who included them in his "gross income", on the grounds that the amounts did not constitute part of his "gross income" as they were not beneficially received. It was held as follows:

- (i) That it is clear that income received is subject to tax notwithstanding the fact that it was tainted with illegality or was received from illegal activities, but this was not the issue in this case, as the issue to be determined was whether the receipt of secret profits by an agent fell within the 'gross income' of the agent and it is accepted that illegally earned income can be taxable.
- (ii) That on the facts of this case there was no 'taking' as set out in *COT v G* 43 SATC 159 as appellant received the proceeds of the sales as well as the original shares and his act was not a unilateral act as in G's case; moreover, on the evidence, the syndicate and its members intended to 'receive' the profits for themselves but this intention will be disregarded.
- (iii) That the word 'received' has various qualifications and not every obtaining of physical control over money or money's worth constituted a receipt for the purposes of the definition of 'gross income' (*CIR v Genn & Co (Pty) Ltd* 20 SATC 113) and this was made clear by *Geldenhuis v CIR* 14 SATC 419 where 'received by' was construed to mean 'received by the taxpayer on his own behalf and for his own benefit'.
- (iv) That in order for there to be a 'receipt' the money must be 'received' by the taxpayer for his own benefit and in this matter the subjective intention of the syndicate and the appellant was to receive the secret profits for themselves but this, however, did not mean that, legally, they had

⁵⁸ *ITC 1792* 69 SATC 236

'received' the profits for their own benefit and to understand the distinction an examination of the law of agency is required.

- (v) That the shares originally acquired by the syndicate belonged not to it but to its principal, M, and this was so because the law does not give effect to the subjective intention of the syndicate and the agent to appropriate the shares or the profits but deems the agent to have received them for and on behalf of the principal.
- (vi) That it followed that by law neither the shares originally bought nor the profits realised belonged to the syndicate or the appellant and were never received by it or appellant in its own right or for its or his benefit but by the principal, M.
- (vii) That, accordingly, the profits of R233 387 and R1 448 229 received by the appellant during the 1990 and 1991 years of assessment did not fall within his 'gross income' for those years.

The decision in this case is no longer relevant since the decision in *MP Finance Group CC (in liquidation) v C:SARS*⁵⁹. The question whether or not amounts are received fraudulently are "received" by the perpetrator "on his or her own behalf and for his or her own benefit" as required by the definition of "gross income" has finally been settled by the decision in the Supreme Court of Appeal case *MP Finance Group CC (in liquidation) v C:SARS*⁶⁰. For a number of years from 1998 one Marietjie Prinsloo, in the words of Howie, P (at 143), "operated an illegal investment enterprise commonly called a pyramid scheme. As is the pattern with such schemes, it readily parted greedy or gullible 'investors' from their money by promising irresistible (but unsustainable) returns on various forms of ostensible investment." For a while, such "returns" were paid to some, before the scheme collapsed owing many millions. Prinsloo operated the scheme through family members, employees and agents soliciting "deposits" in return for commission. She controlled all the entities through which the scheme was conducted and she and her associates appropriated substantial amounts.

From 1 March 1999 to 28 February 2002 the perpetrators knew that the scheme was fraudulent and that it would not be able to pay all the investors what it had promised. In terms of an order of the High Court at Pretoria (on 4 February 2003) all the original

⁵⁹ *MP Finance Group CC (in liquidation) v C:SARS* 69 SATC 141

⁶⁰ *MP Finance Group CC (in liquidation) v C:SARS* 69 SATC 141

entities were consolidated into a single entity named *MP Finance Group CC (in liquidation)*. The Commissioner assessed the CC to tax in respect of the 2000, 2001 and 2002 years of assessment. The liquidators objected on behalf of the CC contending, in the main, that the investment amounts ('deposits') were not "received" within the meaning of "gross income" as defined in the Act, which objection was disallowed. The appeal to the Tax Court was dismissed, the court concluding that the deposits were "receipts" within the meaning of the Act, despite the fact that the scheme was illegal.

The subsequent appeal to the Supreme Court of Appeal was based on two submissions:

- the deposits were not taxable because they were not amounts "received"; and
- any tax payable could not in law be owed by the CC because it was merely a creature of convenience formed after the tax years in question (this submission will not be discussed any further as it is not relevant to the present research).

The court held as follows:

- (i) That in s 1 of the Income Tax Act 58 of 1962 'gross income' meant the total amount 'received by or accrued to or in favour' of a taxpayer during a tax year but this case was concerned with receipt, not accrual.
- (ii) That the inference on the facts must be that whatever intention there was at any time on the part of investors to enter into a contractual relationship with the entities concerned and whatever corresponding intention to contract there might possibly have been on the relevant entities' part prior to 1 March 1999, there can no longer have been any such corresponding intention after that date as from that date onwards the entities run by Prinsloo made their money by swindling the public.
- (iii) That it followed that the amounts that the entities run by Prinsloo were paid in that period were 'received' within the meaning of the Income Tax Act 58 of 1962 and it was for appellant to prove the contrary and that *onus* was not discharged.
- (iv) That the court's judgement in the matter of *Fourie NO v Edeling NO* [2006] 4 All SA 393 (SCA) did not assist appellant as that case dealt with the relationship between investor and scheme and the present case was about the relationship between scheme and *fiscus*; moreover, even if the scheme was legally obliged to repay an investor immediately on receipt, that was

because of the legal principles applicable to the parties to an illegal contract, as between themselves. [own emphasis]

- (v) That an illegal contract is not without all legal consequences and it can have fiscal consequences, *ie* the sole question as between scheme and *fiscus* was whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Income Tax Act and unquestionably they did.
- (vi) That the amounts paid to the scheme were accepted by the operators of the scheme with the intention of retaining them for their own benefit and notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Income tax Act.
- (vii) That, accordingly, the amounts in issue constituted income received and duly taxable and the relevant assessments had been correctly raised.

Thus, it has been made clear that, irrespective of the legal relationship between the perpetrator of the fraud and his or her victim (that of agency or a debtor/creditor relationship, for example), there exists a relationship between the perpetrator and the *fiscus*. There can be no doubt that the intention of the perpetrator of fraud was to obtain and retain the amounts for his or her own benefit and such amounts were therefore “received” for the purposes of “gross income”.

2.2.2.2 “RECEIVED” IN RELATION TO THEFT

A frequently cited case in relation to theft is *Commissioner of Taxes v G*⁶¹. G had been in employment with the government of Rhodesia (now Zimbabwe), entrusted with funds for secret operations. From funds received in excess of what was required for operations, he stole money, which he either deposited in his own bank account or used to purchase goods for himself. The Commissioner of Taxes (in Rhodesia) assessed the thief on the amounts he stole and imposed penalties. He appealed to the Special Court which ruled that the amounts that were stolen were not “received” by him within the meaning of the word in section 8(1) of the Income Tax Act (substantially the same as the definition of “gross income” in the South African Income Tax Act). Against this decision, the Commissioner

⁶¹ *Commission of Taxes v G* 43 SATC 159

appealed to the Appellate Division of the High Court of Zimbabwe. Fieldsend, CJ, after quoting the definition of “gross income”, proceeded to interpret the meaning of the word “received”. He stated (at 163) that “[i]t was common cause that the word ‘received’ was not to be given its ordinary wide meaning and that it had to be limited at least to meaning ‘received as part of the recipient’s patrimony’. He referred to the analogy of borrowing a lawnmower or obtaining money on loan; in neither case the asset or amount would be part of the income of the recipient. He referred to *CIR v Genn & Co (Pty) Ltd v CIR* and *Geldenhuis v CIR* in support of his conclusion, which was formulated as follows:

Whether or not the respondent in this appeal received the money on his own behalf and for his own benefit must depend not only on his own intention but on the intention of the person who passed the money to him. To return for the moment to the lawn-mower, the person who obtains a lawn-mower from his neighbour genuinely intending to return it does not receive the mower in his own right; nor does a person who fraudulently induces his neighbour to lend him his mower intending to keep it for himself. The intention of the taker cannot of itself result in him receiving the thing in his own right. He can only receive the thing in his own right if the giver intends that result as well.

Applying this to the present appeal, the Government never intended that any of the money it paid to the respondent should be his to do with it as he liked. It was paid to him to be applied to a specific Government purpose. Accordingly, at no time did the respondent receive it on his own behalf and for his own benefit. In my view, therefore, it did not fall within his gross income and he should not have been taxed on it.

The appeal was dismissed and the judge held that:

- (i) The word ‘received’ in the definition must be given its ordinary dictionary meaning.
- (ii) Section 8(1) of the Act, read together with its paragraphs (a) to (q), indicates that it is concerned with what comes to a taxpayer from another.
- (iii) The respondent did not receive the money in issue; he stole it.
- (iv) Furthermore, all the money paid to the respondent was paid to him to be applied to a specific Government purpose; accordingly, at no time did the respondent receive the money on his own

behalf and for his own benefit. Consequently, the money in issue formed no part of the respondent's gross income and attracted no tax.

The decision in *MP Finance Group CC (in liquidation) v C: SARS*⁶² has also decided the question whether amounts stolen would fall within the meaning of "received" for the purpose of the definition of "gross income". The intention of the thief would determine that the amount would be received by him or her on his or her own behalf and for his or her own benefit, and the intention of the victim would be irrelevant. The contractual obligation of the thief to return the stolen goods or money would not alter this, as the contractual relationship between the perpetrator and the *fiscus* was the deciding factor.

2.2.2.3 "RECEIVED" IN RELATION TO VOID TRANSACTIONS

*ITC 1545*⁶³ was concerned with two matters:

- amounts received from the purchase and sale of stolen diamonds; and
- profits made from the sale of dried "milk cultures" by the taxpayer to a company owned and controlled by the taxpayer, which operated a scheme involving the buying and selling of dried "milk cultures".

The first matter concerned the deduction in terms of section 11(a) of the Act of amounts to be refunded to the owner of the stolen diamonds and will be discussed in paragraphs 3.2.2 and 3.2.3.

The second matter concerned the profit made by the taxpayer from the sale of dried "milk cultures". It was common cause that the taxpayer was the instigator of the scheme and had, in his personal capacity, also participated as a "grower" in the scheme, making a profit of R1 million by buying and selling to a company to which he had sold his milk

⁶² *MP Finance Group CC (in liquidation) v C: SARS* 69 SATC 141

⁶³ *ITC 1545* 54 SATC 464 (C)

culture “business”, and which was owned and controlled by him. It was submitted on behalf of the taxpayer that the scheme was a lottery in terms of section 2(1) of the Gambling Act 51 of 1965 and the transactions giving rise to the money received were therefore void *ab initio*. The taxpayer was not entitled to the amounts and they were therefore not “received by or accrued to or in favour of” the taxpayer in terms of the definition of “gross income” in section 1 of Act 58 of 1962.

In this matter it was held as follows:

- ...
- (vi) That, assuming, without deciding, that the dried ‘milk culture’ scheme did constitute a lottery in terms of s 2(1) of the Gambling Act 51 of 1965 and that the ‘sales’ in pursuance of which the ‘growers’ were paid for their crop were void *ab initio*, the amounts paid to the ‘growers’ for their ‘milk cultures’ were nevertheless amounts ‘received’ by them in terms of the definition of ‘gross income’ in s 1 of Act 58 of 1962.
 - (vii) That, where an amount is received by a taxpayer on his own behalf and for his own benefit, but in pursuance of a void transaction, there appears to be no reason for holding that such amount is not ‘received’ within the meaning of the definition of gross income in s 1, if that word is to be given its ordinary literal meaning.
 - (viii) That, indeed, it does not follow that because a contract is prohibited by statute and therefore void *inter partes*, it is to be totally disregarded and all the consequences flowing from it ignored.
 - (ix) That the mere fact that the taxpayer was in effect the organiser of the scheme did not justify the inference that he could not also have participated in it as an ordinary ‘grower’ and, instead, must have simply helped himself to the funds available; there being no basis for the conclusion that there was merely a ‘taking’ by the taxpayer as opposed to a receiving.

The Commissioner’s assessments in respect of the amounts of R500 000 in each of the tax years 1984 and 1985 in respect of normal tax were confirmed.

For thieves, the sole reason for stealing is to acquire the stolen property for their own benefit. For the perpetrators of fraud, the same applies. Prostitutes, pimps and brothel owners engage in their activities to acquire income for their own use and benefit. It would appear therefore, that amounts derived from theft, fraud and prostitution are *received* by

the perpetrators of the crimes, irrespective of the intention of the victims, the contractual relationship (or lack thereof) between the perpetrator and the victim, or the fact that the transactions are void.

2.2.3 ACCRUAL

In *CIR v People's Stores (Walvis Bay) (Pty) Ltd*⁶⁴ it was held that an amount accrues to a taxpayer when the taxpayer becomes entitled to it. In *Mooi v SIR*⁶⁵, on the other hand, it was held that an amount accrues to the taxpayer when he or she becomes unconditionally entitled to it. There is no accrual unless the amount has beneficially accrued to the taxpayer⁶⁶. If the taxpayer's entitlement to income is subject to a suspensive condition, then pending the fulfilment of the condition, there is no accrual to the payee⁶⁷. In *CIR v Delfos*⁶⁸ it was held that the use of the disjunctive 'or' between 'received by' and 'accrued to' was intended to give the Commissioner the authority to levy tax on either receipt or accrual. The taxpayer is not liable for tax for an amount that has not accrued, if it has also not been received. Tax is therefore levied on the earlier of the date of receipt or accrual.*

If an amount has accrued to a taxpayer during a year of assessment and the taxpayer has included it in his or her gross income for that year, the Commissioner is bound to include it in the taxpayer's gross income computation for that year⁶⁹. The Commissioner is not entitled to refuse to include an accrual or to postpone assessment until the amount is received⁷⁰. An amount received by the taxpayer before it accrues is taxable in the year of its receipt if it is beneficially received by the taxpayer⁷¹. A thief and the perpetrator of fraud can only become the "rightful owner" of the stolen property after the victim's right to institute a claim against them has lapsed. Thus a thief or the perpetrator of fraud can

⁶⁴ *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 52 SATC 9

⁶⁵ *Mooi v SIR* 1972 AD.

⁶⁶ *Geldenhuis v CIR* 1947 (3) SA 256 © 14 SATC 419 and *CIR v Cape Consumers (Pty) Ltd* (1999) 61 SATC 91

⁶⁷ *Ochberg v CIR* 1933 CPD 256

⁶⁸ *CIR v Delfos* 6 SATC 92

⁶⁹ *Silke Silke on South African Income Tax* volume 1 (2003) 2-4-1

⁷⁰ *Silke Silke on South African Income Tax* volume 1 (2003) 2-4-1

⁷¹ *ITC 702* (1950) 17 SATC 145; *ITC 675* (1949) 16 SATC 238

only, it appears, be *entitled* to the stolen property when the victim's right to sue and the right to institute criminal proceedings have lapsed. This does not, however, preclude the levying of tax because, although the right to the property may not have accrued to the thief or perpetrator of fraud, it would have been received in terms of the tests established in court decisions and thus the Commissioner can levy tax on such amounts on the basis of receipt. In the case of prostitution, the business would be conducted on a cash basis and there would be no need to address the question of accrual.

2.2.4 CAPITAL OR REVENUE

In *CIR v Visser*⁷² a revenue receipt was defined as what is produced by capital or as the fruits of capital. Income also includes the product of a man's wits and energy. Income is derived from capital that has been productively employed or is received for services rendered⁷³; it is sometimes defined as that which is earned by labour⁷⁴. Capital on the other hand is what produces income. Proceeds from the disposal of an income-producing asset by a person not trading in such assets are capital in nature⁷⁵. It is important, for tax purposes, to distinguish between capital and revenue receipts, as they have different tax implications and attract tax at different rates. When a taxpayer is carrying on a trade dealing in commodities or services, what he or she earns is revenue.

The rates of taxation differ if the item to be taxed is capital or revenue in nature. It is therefore vital to determine whether the amounts received by or accrued to prostitutes, thieves and the perpetrators of fraud are capital or revenue in nature. A human body for tax purposes is regarded as capital and what it produces is revenue. Prostitutes thus receive revenue receipts as they use their bodies to obtain income. The same principle applies to fraud and theft as the perpetrators apply their minds to the planning of the crime

⁷² *CIR v Visser* 8 SATC 271

⁷³ *CIR v Visser* 8 SATC 271

⁷⁴ *CIR v Lunn* 1924 AD 94 at 94.

⁷⁵ *Silke on South African Income Tax* volume 1 (2003) 3-3

and use their energy to carry out such plans. It is therefore submitted that thieves and perpetrators of fraud receive revenue receipts when they perform their unlawful activities.

There are circumstances where the “amount” received by a prostitute or thief may be of a capital nature. Prostitutes may receive gifts from their clients. These may be fortuitous and therefore of a capital nature. In terms of paragraph (c) of “gross income”, however, “any amount, including any voluntary award, received or accrued in respect of or by virtue of services rendered or to be rendered or any amount . . . received or accrued in respect of or by virtue of any employment . . .” is included in gross income. In *CIR v Kotze*⁷⁶ the appellant received a reward for providing information to the South African Police. It was held that the taxpayer had been rewarded for a service that he had rendered and that the payment fell within the ambit of paragraph (c) of gross income. It can be argued that the gifts received by prostitutes, though fortuitous, are closely connected with the service they provide and are therefore taxable.

A thief may commit the crime of theft only once as a result of an opportunity that arises. There could be an argument that this, too, is a fortuitous gain and therefore of a capital nature. It is submitted that it may be no different from someone picking up a lost article and keeping it and the fact that theft is illegal should not *per se* expose the value of the stolen item to tax. It could hardly be said that the gains made from fraudulent actions are opportunistic, as these are planned and carried out with intent to defraud.

Taxable capital gains are determined in terms of the Eighth Schedule to the Income Tax Act and the gain so determined is added to taxable income in terms of section 26A of the Income Tax Act. Potential capital gains arising from illegal activities are not discussed in this thesis, except to note that the general principle relating to the taxation of income from illegal activities would apply also to these gains.

⁷⁶ (1998) 64 SATC 447

2.2.5 CONTINGENT RIGHTS

In the case of fraud and theft, the owner of the thing stolen or fraudulently gained has certain rights. These rights and the remedies available to the victims of these crimes are discussed below. The question whether the criminals only conditionally “receive” the fruits of their illegal activities in view of the potential claim for restitution of the property or compensation for loss, is also discussed.

2.2.5.1 OWNERSHIP

Ownership entitles the owner to do within and on his property as he or she pleases within the restrictions imposed by law⁷⁷. Ownership of movable property passes by delivery and ownership of immovable property passes by registration⁷⁸. For ownership to pass the thing must be capable of being held in private ownership, the transferor must be capable of transferring ownership and the transferor must have the intention of passing ownership⁷⁹. When one person defrauds another or steals from another, the person being stolen from or the person being defrauded is not aware of the fraud or theft and hence it cannot be held that they transferred ownership or intended to transfer ownership of their property or money. In terms of the Prescription Act⁸⁰ one can acquire ownership by continuous possession of another person's movable or immovable property for thirty years. In other words if the rightful owner has not claimed his or her property for thirty years the person in possession of such property becomes the owner of the property by default.

In cases of illegal activities the question of ownership only becomes an issue when there is fraud or theft as the rightful owners are not aware that they are parting with their property. The rightful owners in other words do not intend to pass ownership to the thief or the perpetrator of fraud and they acquire a right to claim certain remedies. Thieves and the perpetrators of fraud can thus be the *owner* of property so acquired only after the expiry of

⁷⁷ *Gien v Gien* 1979 (2) SA 113 (T) 1120

⁷⁸ Van der Merwe “Things” LAWSA Vol 27 para 326

⁷⁹ Van der Merwe “Things” LAWSA Vol 27 para 326

⁸⁰ Prescription Act 18 of 1943 section 2

the thirty year period if such property was not claimed by the owner. When dealing with prostitution on the other hand, the prostitute earns the money after performing his or her duties. They therefore acquire ownership of the money immediately and the issue of a rightful owner reclaiming it does not arise.

2.2.5.2 REMEDIES

The victim of a loss due to theft or fraud has remedies, namely the *mandamant van spolie* and the remedy provided for in section 300 of the Criminal Procedure Act⁸¹. Spoliation implies a deprivation and not a mere disturbance of possession⁸². The purpose of a spoliation order or a *mandamant van spolie* is to restore the status *quo* and return the thing or property to a person who is able to prove that he or she was in undisturbed possession of the thing and that he or she was unlawfully deprived of possession⁸³. The order therefore requires the spoliator to restore possession to the person who was in undisturbed possession before the spoliation took place. The applicant must allege and prove unlawful deprivation of possession by the defendant⁸⁴. Possession in this case does not include the proving of ownership; the applicant only has to prove actual physical possession and not a right to possession⁸⁵. This remedy is not an appropriate remedy where property is destroyed⁸⁶. In other words if the victim's money has all been spent by the perpetrator, the victim cannot seek recourse in law using a *spoliation order*.

Section 300 of the Criminal Procedure Act provides that where a person is convicted of an offence which caused damage to another the court may, upon the request of the prosecutor acting on the instruction of the injured person, order compensation for such damage or loss. Such an order can only be made if it has been established that a loss or damage was caused as a direct result of the commission of the offence of which the accused was

⁸¹ The Criminal Procedure Act 51 of 1977

⁸² Pienaar and Mostert *Silberberg and Schoeman's The Law of Property* 5th edition (2006) 295

⁸³ Pienaar and Mostert *Silberberg and Schoeman's The Law of Property* 5th edition (2006) 288

⁸⁴ Harms *Amler's Precedents of Pleadings* 6th edition (2003) 318

⁸⁵ Harms *Amler's Precedents of Pleadings* 6th edition (2003) 317

⁸⁶ Harms *Amler's Precedents of Pleadings* 6th edition (2003) 318

convicted⁸⁷. The order in terms of section 300 was held to be inappropriate where the accused was to be sent to prison for a substantial period of time and has no assets⁸⁸. A victim in whose favour the award is granted may, within sixty days after the date on which the award was made, renounce the award by lodging a document of renunciation with the clerk or registrar of the court⁸⁹. This remedy, like the spoliation order, is only effective if the accused or the defendant has property.

The victim can, if insured, claim the loss from his or her insurance company. The insurance company will then compensate the victim and acquire the right to claim or sue the perpetrator for the amount of the loss. The victim can also, under certain circumstances, claim as a deduction from gross income the value of the loss suffered as a result of theft or fraud. For a loss due to theft or fraud to be deductible, the taxpayer must establish that the risk of the loss which he seeks to deduct from his income is inseparable from, or is a necessary ingredient of, carrying on that particular business⁹⁰. In *ITC 1268*⁹¹, a firm was robbed an amount of money that was in a safe and the loss was claimed as a deduction. The court held that the amount in issue was floating capital and was therefore a loss deductible by the firm⁹². In *ITC 815*⁹³, where trust money was stolen, it was held by the court that the loss incurred in respect of the moneys and the legal expenditure in the attempted recovery thereof, was incurred in the course of operations directed at the production of income and that the risk of loss in the manner in which this had been incurred was a necessary incident of the partnership business; consequently such loss was properly deductible. The fact that the victim may be able to deduct the loss sustained through fraud or theft does not, however, have the effect that the perpetrator of the crime is automatically taxed on the gain.

⁸⁷ *S v Luthuli* 1972 (4) SA 463 (N)

⁸⁸ *S v Baloyi* 1981 (2) SA 227 (T) 229H

⁸⁹ The Criminal Procedure Act 51 of 1977, s300(5)

⁹⁰ *ITC 1242* (1975) 37 SATC 306 (C)

⁹¹ *ITC 1268* 40 SATC 57

⁹² *ITC 1268* 40 SATC 57 at 57

⁹³ *ITC 815* 20 SATC 487

If the victim obtains a judgment against the perpetrator he or she will have thirty years to enforce such a judgment against the perpetrator⁹⁴. The right to institute a prosecution for any offence other than murder, kidnapping, child-stealing, rape, treason or genocide, lapses after twenty years from the date of the commission of the offence⁹⁵. This means that a thief will become the owner of what he or she has stolen if the owner does not sue the thief within thirty years or institute criminal prosecution within twenty years.

2.2.5.3 CONDITIONAL RECEIPT

A condition is the attachment of an event which, on account of its certain future happening, suspends the performance or obligations flowing from a contract⁹⁶. A condition suspends the obligations until the occurrence or the fulfilment of such a condition⁹⁷. A modus on the other hand is a clause that requires a party receiving a benefit to provide security or to agree to do or not to do something in consideration of the benefit bestowed⁹⁸. An amount accrues to a taxpayer if the taxpayer has a vested right to it⁹⁹. When a right is vested in a person it means that such a person is the owner of that right¹⁰⁰. The court in *ITC 903*¹⁰¹ held that if a beneficiary has a vested right the income would properly be taxable in that beneficiary's hands and not in the hands of the donor or trustees. A contingent right on the other hand denotes a right which is conditional and uncertain, as opposed to a vested right which is certain, unconditional and immediately acquired, even though in some instances enjoyment of the right may be postponed¹⁰².

South African law provides that an amount shall accrue to a taxpayer and be included in the taxpayer's gross income when the taxpayer acquires an unconditional right to such

⁹⁴ Prescription Act 18 Of 1943 section 3(2)(e)(ii)

⁹⁵ The Criminal Procedure Act 51 of 1977, section 18

⁹⁶ Christie *The Law of Contract in South Africa* 5 ed (2006) 131

⁹⁷ Christie *The Law of Contract in South Africa* 5 ed (2006) 13

⁹⁸ Christie *The Law of Contract in South Africa* 5 ed (2006) 133

⁹⁹ Silke *Silke on South African Income Tax* volume 1 (2003) 2-16-2

¹⁰⁰ *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 at 175-6

¹⁰¹ *ITC 903* 23 SATC 516 at 519

¹⁰² *Durban City Council v Association of Building Societies* 1942 AD 27, 33-4

income¹⁰³. If the grant of a conditional right to income were to be regarded as giving rise to the accrual of an amount and the condition was in fact never fulfilled, the result would be that the taxpayer would pay tax on something which in reality never became part of his income¹⁰⁴. The principle of levying tax on an amount when all conditions have been fulfilled does not apply if the condition in question only relates to the postponement of the date of enjoyment¹⁰⁵. In cases that involve theft and fraud can it be held that the chance of being sued or having a criminal charge brought against the thief is a condition which delays the imposition of tax? Does the thirty years (or twenty years) it takes for a claim to lapse amount to a suspensive condition in respect to the receipt of income from illegal activities? It is submitted that the fact that restitution may have to be made will not preclude an amount from being included in gross income as the intention of the taker was to keep the stolen goods or money, without contemplating its return. Once again, the decision in *MP Finance Group CC (in liquidation) v C:SARS*¹⁰⁶ is authority for this conclusion.

2.2.5.4 REFUND

The “receipt” of income with an obligation to repay it has been examined in many cases and in the so-called deposit cases¹⁰⁷ it was held that once the taxpayer receives an amount as his own during a tax year, the fact that in terms of his contract he may, in certain circumstances, have to repay that amount, does not have the effect of excluding such amounts from his ‘gross income’ for the year in which he received the amounts. The taxpayer in *ITC 1346*¹⁰⁸ was granted paid study leave under the condition that he returned to the employer and worked for the employer when the research was completed and that failure to do so would result in the taxpayer being ordered to repay the salaries received during the leave. It was held that the salaries had been received and retained by the

¹⁰³ *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 52 SATC 9

¹⁰⁴ *Mooi v SIR* 1972 AD at 678E.

¹⁰⁵ *Silke Silke on South African Income Tax* volume 1 (2003) -16-3

¹⁰⁶ *MP Finance Group CC (in liquidation) v C:SARS* 69 SATC 141

¹⁰⁷ Including *Brookes Lemos Ltd v CIR* 14 SATC 295 and *Grease (SA) Ltd v CIR* 17 SATC 358

¹⁰⁸ *ITC 1346* 44 SATC 31

taxpayer as his own during the tax year in question, and that the contingent liability to repay the university did not exclude the said sum from the taxpayer's gross income for that year¹⁰⁹. In *ITC 1669*¹¹⁰ the taxpayer company processed raw hides on behalf of its shareholders and invoiced them for this. At the end of the tax year the company granted its shareholders rebates on the amounts paid for the processing of hides. The company then claimed the rebates as a deduction. The court held that the fact that the company later repaid part of the amounts it received did not have the effect of excluding such amounts from its gross income¹¹¹.

These cases raise an inference that the South African tax system levies tax on taxpayers who receive amounts as their own, regardless of the obligation to repay them. A contrasting decision was made in *C v COT*¹¹² where the taxpayer recorded deposits from customers as creditors in his books of account, deposited them into his only bank account and used them to meet expenses of the business. The court held that the deposits did not constitute ordinary revenue income but were working capital which may be equated to a bank loan and were thus not taxed¹¹³. As this case was heard by a Zimbabwean court (then Rhodesian) it does not create a binding precedent in South Africa. South African case law therefore indicates that the obligation to refund an amount does not amount to a hindrance of beneficial receipt and thus if the taxpayer beneficially received an amount that taxpayer is liable for tax on the amount so received. When a thief or the perpetrator of fraud "receives" an amount from illegal activities they do so for their own benefit and thus receive it for tax purposes. The chance of a case being brought against a taxpayer will, as tax law stands, have no effect on the tax liability for the stolen or embezzled money as it would have been received for the perpetrator's own benefit. It does not matter for tax purposes that the taxpayer was not entitled to retain the goods or the money. The only factor that matters is that it was received by the taxpayer with the intention of retaining it

¹⁰⁹ *ITC 1346* 44 SATC 31 33

¹¹⁰ *ITC 1669* (1999) 61 SATC 479

¹¹¹ *ITC 1669* (1999) 61 SATC 479

¹¹² *C v COT* 46 SATC 57

¹¹³ *C v COT* 46 SATC 57 at 62

for his or her own benefit¹¹⁴. The argument is not relevant when dealing with prostitution as there is no victim *per se* who at law can have a right to claim the money earned by the prostitute. In the case of a prostitute and those living on the earnings of prostitution, what is received or what accrues would be included in gross income.

2.2.6 EARNINGS FLOWING FROM ILLEGAL ACTIVITIES

Prostitutes may work in a brothel and earn salaries or commission; thieves in a syndicate may be employed to steal on behalf of a crime “boss” and earn salaries or commission; the perpetrators of fraudulent schemes may employ others at a salary or for commission to work for them. Those who work or provide services in an illegal business are taxable on their earnings in terms of paragraph (c) of the definition of “gross income” as they provide services in return for fees. The fact that the business is illegal would not alter this principle.

2.3 CONCLUSION

Revenue laws in South Africa cast the net wide so as to catch and levy tax on a wide range of income¹¹⁵. For income from illegal activities (or legal activities) to be taxed it must fall within the ambit of the gross income definition¹¹⁶. When determining the tax liability of a taxpayer the legality or illegality of a business carried on by the taxpayer is immaterial¹¹⁷. Illegal activities can be grouped into two categories: a legal trade tainted by an illegal activity and activities that are patently illegal¹¹⁸. In *CIR v Insolvent Estate Botha*¹¹⁹ it was held that although illegal agreements are void *inter partes* this does not rob them of all legal results, in other words an illegal contract is not without all legal consequences, it

¹¹⁴ *MP Finance Group CC v Commissioner for South African Revenue Service* [2007] SCA 71 (RSA) [12]

¹¹⁵ *ITC 1199 36 SATC* 16 at 19

¹¹⁶ Warneke and Warden 'Fraudulent transactions: are the receipts taxable?' (2003) *Tax Planning: Corporate and Personal* 17 (2) at 26

¹¹⁷ *CIR v Delagoa Bay Cigarette Company* 32 SATC 47

¹¹⁸ Monterio 'Money doesn't smell' (2005) *Without Prejudice* 5 (7) at 12-13.

¹¹⁹ *CIR v Insolvent Estate Botha* 52 SATC 47

continues to have fiscal consequences. This was also the decision in *MP Finance Group CC v C: SARS*¹²⁰.

Court decisions have established the principle that income is taxable, regardless of the legality or illegality of the source from which it was derived. Furthermore, the fact that the perpetrators of the crimes of theft or fraud may have to return the goods or compensate their victims does not suspend the inclusion of the amounts in their “gross income”.

¹²⁰ *MP Finance Group CC v Commissioner for South African Revenue Service* [2007] SCA 71 (RSA) [12]

CHAPTER 3: TAXABLE INCOME FROM ILLEGAL ACTIVITIES – THE GENERAL DEDUCTION FORMULA

3.1 INTRODUCTION

The previous chapter discussed the inclusion of amounts derived from illegal activities in the “gross income” of the perpetrators of the crimes and concluded that the illegality of the business from which the receipts or accruals arose did not prevent their inclusion in “gross income”. The perpetrators of the illegal activities of prostitution, theft or fraud may incur expenses in deriving their ill-gotten income, and this aspect is discussed in the present chapter. In doing so, the second objective of the research is addressed: to analyse the deductibility of expenses incurred in the production of income from illegal activities.

3.2 THE GENERAL DEDUCTION FORMULA

The preamble to section 11, section 11(a), section 23(f) and section 23(g) of the Income Tax Act constitute the so-called general deduction formula which forms the cornerstone of the deduction provisions of the Income Tax Act. The preamble to and section 11(a) provide as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature . . .

and sections 23(f) and 23(g) provide as follows:

No deduction shall in any case be made in respect of the following matters, namely –

- (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section *one*;

- (g) any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade . . .

For expenditure or a loss to be deductible it must meet all the requirements laid down in the preamble to section 11 and section 11(a) and not be prohibited by section 23 of the Income Tax Act. Failure to meet any one requirement results in disallowing part of or the whole deduction claimed¹²¹. In *Sub-Nigel LTD v CIR*¹²² it was held that the court is not concerned with deductions which may be considered proper from the point of view of a trader or an accountant, but is concerned with the deductions which are permissible according to the language of the Act. Regard must therefore be had to the Act in order to ascertain whether or not the deductions sought to be made are permissible¹²³.

3.2.1 CARRYING ON A TRADE

The first requirement, in order to be granted the deductions provided for in the Income Tax Act (unless a specific section of the Income Tax Act provides otherwise), is that the person should be carrying on a trade. The definition of “trade”¹²⁴ includes “every profession, trade, business, employment, calling, occupation or venture . . .”. The first question that arises is whether or not a prostitute, a thief or the perpetrator of fraud, engaged in criminal activities, is carrying on a trade. A trade is anything that occupies the attention and time of any person for purposes of making a profit¹²⁵. A venture on the other hand means a transaction in which a person risks something with the object of making a profit¹²⁶. Trade implies an active occupation as opposed to a passive earning of income¹²⁷. The word trade has a wide meaning and one can conclude that all activities undertaken by the taxpayer will constitute a trade as long as they are done with the object of earning income¹²⁸. An activity can be a trade, but not necessarily a business¹²⁹. There are passive

¹²¹ Huxham and Haupt *Notes on South African Income Tax* 25th edition (2006) 63

¹²² *Sub-Nigel Ltd v CIR* 15 SATC 381

¹²³ *Sub-Nigel Ltd v CIR* 15 SATC 381

¹²⁴ Income Tax Act 58 of 1962, s1

¹²⁵ *Jones v Welsh Insurance and Corporation LTD* 54 TLR 52

¹²⁶ *ITC* 368 (1936) 9 SATC 211

¹²⁷ Huxham and Haupt *Notes on South African Income Tax* 25th edition (2006) 62

¹²⁸ De Koker and Urquhart *Income Tax in South Africa* 10-5

means of earning income which the Income Tax Act recognises as trades and these activities are specifically provided for in the definition of "trade"¹³⁰, for example, the letting of property and the use or grant of use of patents, copyright, etc. In *ITC 770*¹³¹ it was held that the word trade was intended to embrace every profitable activity and thus the word should be given the widest meaning possible. In *De Beers Holdings (Pty) Ltd v CIR*¹³², on the other hand, it was held that the attainment of a profit is not the defining feature in a trading transaction as a trader may trade at a loss in order to gain a commercial advantage. Carrying on a trade does not necessarily give rise to income in any particular year of assessment¹³³. This means that not earning any income does not have any effect on whether or not a taxpayer is carrying on a trade. A taxpayer can therefore be carrying on a trade even when he has no objective of making a profit or where he deliberately sets out to make a loss¹³⁴. In *ITC 615*¹³⁵, where the taxpayer was hiring and sub-letting the leased property at the same rental paid by the original tenant, the taxpayer was held to be carrying on a trade. The taxpayer's motive for carrying on a trade is irrelevant¹³⁶. It is also irrelevant whether the taxpayer realises the risks inherent in the transaction¹³⁷.

The Income Tax Act, in defining a trade, does not refer to legality, morality or public policy. The definition in the Act is wide and thus one can argue that an illegal activity like prostitution amounts to a trade. South African law also provides that a person can carry on more than one trade; thus one can be legitimately employed and, at the same time, be the master mind behind a fraudulent scheme and be carrying on two trades. The definition of trade in section 1 of the Income Tax Act and related case law indicates that, for a trade to be carried on, the taxpayer must actively do something and intend to make profit, either now or in future. Thieves and the perpetrators of fraud must actively do something - apply

¹²⁹ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 277

¹³⁰ *Income Tax Act* 58 of 1962 s 1

¹³¹ *ITC 770* 19 SATC 216

¹³² *De Beers Holdings (Pty) Ltd v CIR* 47 SATC 229

¹³³ De Koker and Urquhart *Income Tax in South Africa* 10-7

¹³⁴ De Koker and Urquhart *Income Tax in South Africa* 10-7

¹³⁵ *ITC 615* (1946) 14 SATC 399

¹³⁶ De Koker and Urquhart *Income Tax in South Africa* 10-7

¹³⁷ De Koker and Urquhart *Income Tax in South Africa* 10-8

their time, wits and skill in the planning and execution of theft or fraud - and they must do this in order to make a profit. Lord Denning stated in *Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd*¹³⁸ that a gang of burglars is not engaged in a trade although they have an organisation, spend money on equipment, acquire goods by their efforts and sell them at a profit. The decision in this United Kingdom case does not appear to reflect the position in South African law.

In *Burgess v CIR*¹³⁹ it was held that if a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, that taxpayer will not cease to carry on a trade merely because his purpose is to obtain a tax advantage. The courts have held that a lack of continuity or a lack of a profit motive may exclude the taxpayer's actions from being held to be a trade¹⁴⁰. When a taxpayer carries on more than one trade in the Republic deductions under section 11 can be made from his aggregate income from all such trades¹⁴¹. This is subject to the provisions of section 20A¹⁴², which limits the deduction of expenses to the income from a trade carried on by a person who also earns remuneration, under certain circumstances.

Case law raises an inference that prostitutes, brothel owners and pimps are carrying on a trade because of the active application of their time and skill in an endeavour to produce income. It is less certain whether fraud or theft is a trade because of its inherent illegality and immorality even though in theory it meets the requirements of trade. Where fraudulent activities or theft are carried on continuously in a business-like manner, this would appear to constitute a trade. Single instances of these offences may not constitute a trade, although it was held in *Stephan v CIR*¹⁴³ that the first and only operation was a business venture. If the fraud or theft is planned and carried out in a businesslike manner, even one instance may constitute a trade. It is less clear, however, in the case of a once-

¹³⁸ *Griffiths (Inspector of taxex) v JP Harrison (Watford) Ltd* 1963 AC 1 at 20

¹³⁹ *Burgess v CIR* (1993) 55 SATC 185

¹⁴⁰ De Koker and Urquhart *Income Tax in South Africa* 10-5

¹⁴¹ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 276

¹⁴² Income Tax Act 58 of 1962

¹⁴³ *Stephan v CIR* 32 SATC 54

off opportunistic offence, rather than an ongoing activity, whether this would constitute a trade.

Once it has been established that the taxpayer is carrying on a trade, any loss or expenses incurred would have to satisfy all the other requirements of the general deduction formula to qualify as a deduction.

3.2.2 ACTUALLY INCURRED

For an expense to be deductible it must actually have been incurred. Expenditure is actually incurred when it has been paid and when the taxpayer is under an unconditional obligation to pay the amount in question¹⁴⁴. In *Caltex Oil (SA) Ltd v SIR*¹⁴⁵ it was held that the expression “actually incurred” means all expenditure for which liability has arisen even if that liability has not yet been paid.

The victim of a loss due to theft or fraud has legal remedies in the form of the *mandament van spolie* and the remedy provided for in section 300 of the Criminal Procedure Act, 51 of 1977 (to be referred to as the Criminal Procedure Act). The purpose of a spoliation order or a *mandament van spolie* is to restore the *status quo* and return the thing or property to a person who is able to prove that he or she was in undisturbed possession of the thing and that he or she has been unlawfully deprived of possession¹⁴⁶. This remedy is not an appropriate remedy where property is destroyed¹⁴⁷. Section 300 of the Criminal Procedure Act provides that where a person is convicted of an offence which caused damage to another the court may, upon the request of the prosecutor acting on the instruction of the injured person, order compensation for such damage or loss.

A thief is under an obligation to repay stolen money or pay compensation for stolen property, but this obligation is subject to the victim obtaining judgment against the

¹⁴⁴ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 278

¹⁴⁵ *Caltex Oil (SA) Ltd v SIR* 25 SATC 67

¹⁴⁶ Pienaar and Mostert *Silberberg and Schoeman's The Law of Property* 5th edition (2006) 295

¹⁴⁷ Harms *Amler's Precedents of Pleadings* 6th edition (2003) 318

perpetrator¹⁴⁸. In other words, a thief is not under an unconditional obligation to pay the amount until a judgment is obtained against him or her. Thus incurring expenditure or suffering a loss, when there is a condition or an obligation to repay the stolen amount, is suspended until the rightful owner obtains a judgment ordering the perpetrator to repay the stolen amount. In *CIR v Golden Dumps (Pty) Ltd*¹⁴⁹ the expenditure in question was dependent on a court decision and the decision was delivered a few years after the case was brought to court. The court held that the expense was only actually incurred in the year of assessment in which the court handed down its decision. If an amount is not claimed as a deduction in the year it was incurred, the taxpayer forfeits the right to claim it in subsequent years¹⁵⁰. Expenditure, other than refunds, restitution or the payment of compensation, incurred by thieves, perpetrators of fraud and those earning their income directly or indirectly through prostitution, or the payment of salaries and wages for the services of others involved in the illegal trade, is expenditure actually incurred when the obligation to pay has arisen, with no conditions attached. When the existence of a liability is contingent and dependent upon the happening of an event the liability is not incurred until the event happens¹⁵¹. In *Nationale Pers BPK v KBI*¹⁵² it was held that if payment is conditional the expense is only incurred when the condition is fulfilled. An expense is therefore not incurred if there is a chance that it will not arise.

As there is no guarantee that the victim will obtain a judgment and the exact amount to be granted in the judgment is unknown, the expense of reimbursing the victim is not actually incurred until the judgment is obtained. When expenditure has actually been incurred during that year of assessment, but the amount cannot be quantified, it must be estimated using all available information¹⁵³. When a liability is contingent it is incurred in the year of assessment the condition is fulfilled¹⁵⁴. In *CIR v Edgars Stores Ltd*¹⁵⁵ it was held that,

¹⁴⁸ *ITC 1545* 54 SATC 464

¹⁴⁹ *CIR v Golden Dumps (Pty) Ltd* 55 SATC 198

¹⁵⁰ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 278

¹⁵¹ *Edgars Stores Ltd v CIR* 50 SATC 81

¹⁵² *Nationale Pers Bpk v KBI* 1986 (3) SA 549 (A)

¹⁵³ Huxham and Haupt *Notes on South African Income Tax* 25th edition (2006) 64

¹⁵⁴ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 280

where the existence of a liability is certain and established within a tax year, but the amount in question cannot be accurately determined at the end of the tax year the liability for that amount is nevertheless regarded as having been incurred in that tax year. When an expenditure is actually incurred in year one and paid in the next year of assessment if it meets the requirements in section 11(a) it is deductible in year one¹⁵⁶. In *ITC 1499*¹⁵⁷ the taxpayer sought to claim expenditure which was subject to a *bona fide* dispute and it was held that expenditure lacked the degree of certainty and finality to render it actually incurred. The fact that the victim of a crime may bring a claim for a certain amount does not necessarily mean that he or she will be granted a judgment equal to the claim and therefore the thief cannot determine the actual amount for which he or she is liable until the judgment is handed down. In *ITC 840*¹⁵⁸ a lessor incurred expenditure on fixtures which were to become part of the lessee's property after five years of the lease. The court held that the lessor could not claim the expenditure as it would only be incurred when he loses ownership of the fixtures. The Income Tax Act disallows the deduction of expenditure which is contingent, threatened or expected¹⁵⁹. As the Act refers to "actually incurred", this implies that accounting provisions are not deductible under this section¹⁶⁰. Notional expenditures are also not deductible under the provisions of section 11(a)¹⁶¹.

The first matter of concern in *ITC 1545*¹⁶² was the amounts received from the purchase and sale of stolen diamonds. A number of submissions were made by counsel, on behalf of the trustees of the taxpayer's insolvent estate. In the context it was common cause that the taxpayer was aware that the diamonds he bought and sold were stolen and that his conduct amounted to theft. It was also common cause that the proceeds of the sales amounted to a "receipt or accrual" within the meaning of "gross income" – it was not a case in which there had been no receipt but merely a "taking" by a thief. It was submitted

¹⁵⁵ *Edgars Stores v CIR 50 SATC 81*

¹⁵⁶ *Williams Income Tax and Capital Gains Tax In South Africa Law and Practice 278*

¹⁵⁷ *ITC 1499 53 SATC 266*

¹⁵⁸ *ITC 840 21 SATC 424*

¹⁵⁹ *Williams Income Tax and Capital Gains Tax In South Africa Law and Practice 280*

¹⁶⁰ *Huxham and Haupt Notes on South African Income Tax 25th edition (2006) 64*

¹⁶¹ *Williams Income Tax and Capital Gains Tax In South Africa Law and Practice 279*

¹⁶² *ITC 1545 54 SATC 464 (C)*

that the taxpayer, because of his conduct that amounted to theft, rendered himself liable to the owner of the diamonds for their return or their value. This liability was “an inseparable and necessary concomitant of the ‘trade’ of dealing in stolen diamonds and that, as it arose immediately with each transaction, it had constituted deductible expenditure in terms of s 11(a) of Act 58 of 1962 for each of the years in which a profit was made.” (at page 467). It was also submitted that the assessments should be set aside and the taxpayer be re-assessed once the *quantum* of the owner’s claim had been determined (the owner had instituted proceedings against the taxpayer in later years of assessment). The Commissioner’s submission was that whatever the taxpayer’s liability might turn out to be, it did not constitute expenditure incurred in the relevant years of assessment.

Scott, J stated (at 467) that “[i]t is well established that in order for expenditure to be deductible it must have been incurred in the year of assessment concerned. In order to be deductible the liability must be one which is definite and absolute and not one which is merely contingent”.

It was held as follows in respect of this aspect of the case:

- ...
- (iii) That the taxpayer’s liability to the owner for the return of the diamonds or their value did not constitute deductible expenditure in terms of s 11(a) of Act 58 of 1962 as whether the taxpayer is ever made to compensate the owner or not depended in each case not only upon whether his crime was detected but also on the non-happening of an uncertain future event.
 - (iv) That, therefore, until at least the owner institutes proceedings against the taxpayer to recover his loss from him rather than from any other party, the taxpayer’s liability did not amount to ‘expenditure . . . actually incurred’ within the meaning of s 11(a).
 - (v) That the proceedings against the taxpayer arising out of the transactions in question and brought by the owner of the stolen diamonds were instituted subsequent to the years of assessment in question and it followed that the appeal against the Commissioner’s assessment of the taxpayer for normal tax in respect of the years ending 30 June 1980, 1981 and 1982 had to fail. [own emphasis]

Any contention that a thief or the perpetrator of fraud incurred a liability to return the property or to make good the loss of the victim of the crime *at the time the amounts were received* by him or her, would therefore fail.

The liability to repay the owner of the property or to return the property obtained by theft or fraud, or to compensate the victim, is thus dependent on judgment being obtained against the perpetrator and therefore the liability is not incurred until judgment is handed down, unless the payment is made voluntarily. Only at the stage where the judgement is obtained or the payment is voluntarily made, will the liability actually be incurred and, provided it meets the other requirements of section 11(a), will it be deductible. Expenses actually paid by persons earning their income through the activity of prostitution, through theft or fraud, or expenses incurred in carrying on other illegal activities, for which there is a legal liability to pay will, however, have been “incurred” for the purposes of the general deduction formula.

3.2.3 DURING THE YEAR OF ASSESSMENT

The expenditure which the taxpayer claims as a deduction must be incurred during the year of assessment in which it is claimed. For example, in *Concentra (Pty) Ltd v CIR*¹⁶³, expenditure relating to directors’ expenses which had arisen in earlier years was not claimed as a deduction in those years and, by not doing so, the right to claim a deduction in terms of section 11(a)¹⁶⁴ was forfeited. When looking at the Income Tax Act as a whole, it deals with one tax year, in that taxpayers are assessed on income they receive in one year of assessment and thus the deductions should also be claimed for that one year of assessment¹⁶⁵. *ITC 1624*¹⁶⁶ dealt with a close corporation carrying on business as customs clearing and freight forwarding agents (discussed in detail in paragraph 2.2.2.1). The taxpayer fraudulently rendered accounts to a client reflecting wharfage fees disbursed in

¹⁶³ *Concentra (Pty) Ltd v CIR* (1942) CPD 12 SATC 95

¹⁶⁴ *Income Tax Act* 58 of 1962

¹⁶⁵ *Sub Nigel Ltd v CIR* 15 SATC 381

¹⁶⁶ *ITC 1624* 59 SATC 373

excess of the actual expenditure incurred. One of the submissions made by the appellant (the close corporation) was that it was entitled to claim as a deduction the same amount that it had overcharged the client (for which a provision had been created in the financial statements) as it had become subject to a simultaneous and corresponding liability to repay it. The court held as follows:

...

- (iv) That it does not follow from the fact that appellant had an obligation to restore what it had unlawfully taken from A that it 'actually incurred' 'expenditure' for that sum; it may well be that if it paid the amount it would incur a loss which would be treated as having been incurred in the production of its income as a necessary concomitant of the trade dishonestly carried on by it but that has not happened.
- (v) That it is not a correct reflection of what happened in the present case to say that appellant had voluntarily or even to say simply that it expended the amount it is liable to repay to A; it took the money with the obvious intention of keeping it in the hope that its fraud would not be found out and on the basis that the amount would be repaid if its misconduct was discovered, but only then.
- (vi) That the appellant had recognised that it had a liability to pay A the disputed amount so as to result in a loss to it and treated its position as such *ab initio* (ie in the year of assessment) is, in any event, difficult to accept as a probability; in any event, when the financial statements for the year of assessment in question were prepared, A had not yet discovered the fraud or in any way intimated that it intended to claim the money of which it had been defrauded – at most, it is probable that appellant had made a provision for the disputed sum and it did so, not by treating what it owed A as a liability for the repayment of stolen funds but by means of recording fictitious 'purchases'.
- (vii) That, accordingly, the disputed sum could not be described as expenditure or a loss actually incurred in the production of appellant's income in terms of s 11(a) of the Income Tax Act 58 of 1962 in the year of assessment concerned and it was also not laid out or expended for the purpose of trade as required by s 23(g) of the Income Tax Act 58 of 1962. [own emphasis]

The obligation to pay or refund the rightful owner of money or property arises after the money has been stolen from such owner. The obligation in such cases is not certain as the obligation is further dependent on the victim obtaining judgment against the perpetrator, unless the payment is made voluntarily. This means that the expenditure



can only be claimed in the year it is actually paid, if it meets all the other tests set out in section 11(a) of the Income Tax Act.

3.2.4 IN THE PRODUCTION OF INCOME

The leading case dealing with the phrase “in the production of income” is *Port Elizabeth Electric Tramway Co Ltd v CIR*¹⁶⁷ which involved the payment of compensation to a driver of a tram injured during the course of his employment and who subsequently died from his injuries. The company resisted the claim in legal proceedings but eventually was ordered to pay damages and also incurred legal costs in resisting the claim. The question was whether these expenses were incurred “in the production of income”. Watermeyer, AJP held that the test is twofold: the act to which the expenditure is attached must be performed in the production of income and the test to be applied is subjective: if it is performed *bona fide* for the purpose of carrying on the trade which earns the income and the expenditure in question must be so closely linked to such act that it can be regarded as part of the cost of performing it. It was held further that whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the efficient performance of such operations, they are deductible provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

The expenditure and losses referred to in the Income Tax Act refer to the outgoings and losses incurred in the course of or by reason of the ordinary operations undertaken for the purpose of conducting business¹⁶⁸. For expenditure to qualify as a deduction, the expenditure must relate to a trade carried on by the taxpayer¹⁶⁹. The expenditure must have been incurred in order to produce income for the taxpayer¹⁷⁰. The words “incurred in the production of income” mean actually incurred in the course of or by reason of ordinary business operations undertaken for the purposes of conducting the business¹⁷¹. In

¹⁶⁷ 1936 CPD 241, 8 SATC 13

¹⁶⁸ *Lockie Bros Ltd v CIR* 32 SATC 150 at 151-2

¹⁶⁹ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 276

¹⁷⁰ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 284

¹⁷¹ *Lockie Bros LTD v CIR* 32 SATC 150

*Weinburg v CIR*¹⁷² it was held that an amount is not deductible if it was not incurred in rendering any service in the normal course of business. In *COT v Rendle*¹⁷³, on the other hand, the court mentioned three different types of expenses that can be incurred in the production of income and these are expenses necessary for the performance of the trade, expenses incurred for *bona fide* efficient performance of trade activities and expenses attached to the performance by chance. Section 11(a) does not require expenditure to produce income in the same year of assessment in which it was incurred¹⁷⁴. If the section 11(a) requirements are all met the amount is deductible even if it does not produce income in that year of assessment or in any year of assessment¹⁷⁵. The court is not concerned with whether a particular item of expenditure produced any part of the income but it is concerned with whether the expenditure was incurred for purposes of earning income¹⁷⁶. If expenditure is incurred for the purpose of producing income, the fact that it does not produce income in that year or in any year is irrelevant¹⁷⁷. Operational costs are costs that are naturally and reasonably regarded as expenses that are part of the cost of performing the operations¹⁷⁸. The court has a duty to assess the closeness of the connection of an expense to the income-earning operations of the business, having regard to the purpose of the expenditure¹⁷⁹.

It appears to be clear that, provided they meet the other requirements of the general deduction formula, the expenses (excluding the amounts specifically prohibited in section 23(o)¹⁸⁰) incurred by prostitutes, brothel owners and pimps would be expenses incurred in the production of their income. The situation with regard to the expenses incurred by thieves and the perpetrators of fraud and, in particular, the expenses incurred in compensating the victims of their crimes is not so clear.

¹⁷² *Weinburg v CIR* 14 SATC 210

¹⁷³ *COT v Rendle* 26 SATC 326

¹⁷⁴ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 282

¹⁷⁵ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 282

¹⁷⁶ *Sub Nigel Ltd v CIR* 15 SATC 381

¹⁷⁷ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 286

¹⁷⁸ *CIR v Genn and Co (Pty) Ltd* 20 SATC 113

¹⁷⁹ *CIR v Genn and Co (Pty) Ltd* 20 SATC 113

¹⁸⁰ Income Tax Act, 58 of 1962

In *COT v Rendle*¹⁸¹ it was held that the deductibility of fortuitous expenditure depends on whether the chance or risk of it being incurred is sufficiently closely connected with the taxpayer's business operations. The taxpayer must show that the risk of the occurrence of the action which gives rise to the expenditure was inseparable from or is a necessary incident of carrying on of the particular trade¹⁸². In *ITC 233*¹⁸³ the taxpayer was a stevedore and a passerby was killed by an article that fell from a net while cargo was being off-loaded. The court held that the payment of damages is incidental to the trade of a stevedore and is deductible.

Involvement in illegal activities is accompanied by the risk of imprisonment or a civil action and in cases of fraud and theft the risk of being ordered to refund the victim. Expenses associated with these risks cannot be said to have been incurred in the production of income as they relate to a "penalty" in respect of income received in an earlier period and cannot be said to have been incurred *bona fide* for the purpose of producing income¹⁸⁴. To qualify for deduction they would have to be inseparable from the type of trade being carried on and their incurrence a concomitant of the business of involvement in illegal activities. In *Joffe and Co (Pty) Ltd v CIR*¹⁸⁵ it was held that all expenditure attached to the performance of the operations which constitute the carrying on of a trade would be deductible and also expenditure which is not attached to trading operations but is *bona fide* incurred for the purposes of trade. The words 'incurred in the production of income' must be given the meaning of 'actually incurred in the course of and by reason of the ordinary business operations undertaken for the purpose of conducting the business'.

¹⁸¹ *COT v Rendle* 26 SATC 326

¹⁸² *COT v Rendle* 26 SATC 326

¹⁸³ *ITC 233* 6 SATC 259

¹⁸⁴ *Port Elizabeth Electric Tramways Co v CIR* 8 SATC 13

¹⁸⁵ *Joffe and Co (Pty) Ltd v CIR* 13 SATC 354

In *COT v Rendle*¹⁸⁶, the expenditure incurred by the respondent in the reimbursement of the companies in respect of the moneys misappropriated by the firm's employee was, however, held to be sufficiently closely connected with the firm's business operations as to be regarded as part of the cost of performing those operations. It would therefore appear that the repayment of amounts stolen, the return of stolen property or the compensation paid by the thief or the perpetrator of the fraud to the victim for the loss of property, if it occurred during the same year of assessment in which the proceeds were included in gross income, may be allowed as a deduction (subject to the other requirements relating to deductions). It would appear to be an inevitable concomitant of the "trade" of theft or fraud that the need to compensate victims would arise.

3.2.5 NOT OF A CAPITAL NATURE

Expenditure of a capital nature does not qualify for deduction in terms of the general deduction formula. As is the case with receipts and accruals of a capital nature, there is no definition in the Income Tax Act of what constitutes an expense of a capital nature. It has been left to the courts to provide a number of tests which can be applied under different circumstances. In *CIR v George Forest Timber Co Ltd*¹⁸⁷ it was held that money spent in creating or acquiring an income-producing concern or source of future income (as opposed to money spent in working it) was capital expenditure. In *New State Areas Ltd v CIR*¹⁸⁸ it was held that expenditure which is incurred for the purpose of establishing, improving or adding to the equipment of the income-producing structure is capital expenditure; whereas expenditure which is incurred as part of the cost of performing the income-producing operations is revenue expenditure.

Persons earning their income from illegal activities, including prostitution, theft and fraud, may incur expenditure in acquiring capital equipment needed for their trade. This expenditure which is linked to their income-earning structure would not be deductible in terms of section 11(a). Provided the expenditure met the requirement of "trade", the

¹⁸⁶ *COT v Rendle* 26 SATC 326 at 333

¹⁸⁷ 1924 AD 516, 1 SATC 20

¹⁸⁸ 1946 AD 610, 14 SATC 155

capital expenditure may qualify for deduction in terms of section 11(e) – wear-and-tear allowance – or one of the other provisions of the Income Tax Act providing for the write-off in instalments of other types of capital expenditure.

3.2.6 THE DEDUCTIBILITY OF EXPENDITURE AND LOSSES CONNECTED WITH ILLEGAL ACTIVITIES

As is the case with the definition of “gross income”, the provisions comprising the general deduction formula (or any other provisions) make no mention that the deductions and allowances are prohibited in the case of illegal activities. In the 1918 case, *CIR v Delagoa Bay Cigarette Co*¹⁸⁹, Bristowe J, held that “if the income [from an illegal business] itself is taxable, it follows I think that if the prizes had been a legitimate deduction [and not a disposal after they had been earned] had the business been legal, they would equally be a legitimate deduction if the business is illegal”. A contrary view (albeit an *obiter dictum*) was expressed by Watermeyer, AJP in the case of *Port Elizabeth Electric Tramway Co Ltd*¹⁹⁰ when he stated that: “[w]here the act in question, though performed in the production of income, is unlawful or negligent, the expenditure attendant upon such act would probably not be deductible”. Admittedly this related to the unlawfulness of the expenditure itself and not the illegality of the business. However, there still appears to be a measure of doubt in this regard.

Criminal penalties are not deductible¹⁹¹. In *ITC 1199*¹⁹² it was held that if fines for criminal conduct would qualify as a deduction there would be no public policy barrier against allowing such deduction. These fines are not deductible even if the crime was committed in the course of income-earning operations¹⁹³. This non-deductibility is based on public policy and supports the legislature's intention to decrease crime and thus

¹⁸⁹ *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391, 32 SATC 47

¹⁹⁰ *Port Elizabeth Electric Tramway Co Ltd* 1936 CPD 241, 8 SATC 13

¹⁹¹ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 337

¹⁹² *ITC 1199* 36 SATC 16 19

¹⁹³ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 337

allowing the deduction would be inconsistent with the aim of the legislature¹⁹⁴. Criminal sanctions are not imposed on the taxpayer *qua* trader but as a personal punishment¹⁹⁵. A fine is a personal punishment not a cost of performing business operations¹⁹⁶. In *ITC 1490*¹⁹⁷ the taxpayer was a cartage contractor deriving its income from transporting goods. The taxpayer wanted to deduct traffic fines incurred in that year of assessment. The court held that fines for criminal conduct in the carrying out of business operations cannot be regarded as expenditure in the production of income and therefore the expenditure does not qualify for deduction under section 11(a). In a Rhodesian case, *ITC 1212*¹⁹⁸, it was held that a deduction of fines incurred was disallowed on the grounds that the section that provides for deductions only provides for the deduction of commercial losses and a loss that results from a breach of law is not a commercial loss. Persons involved in illegal activities would frequently have to pay fines or penalties for so doing and it is clear that these expenses would not be deductible.

The arguments raised in the cases referred to above that to allow the deduction of fines and penalties would be contrary to public policy, could also be raised against the granting of the deduction of other expenses incurred in the course of carrying on criminal activities. Jacobson¹⁹⁹, however, argues that the use of public policy to disallow expenditure is against the philosophy of the Income Tax Act, as a tax collection statute.

The only provision in the Income Tax Act that deals directly with illegal activities is section 23(o) which provides that no deduction will be allowed for any expenditure that constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004, and where a payment constitutes a fine imposed as a result of an unlawful activity. Section 3 of the Combating of Corrupt Activities Act describes the general offence of corruption, which relates to accepting or giving a

¹⁹⁴ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 337

¹⁹⁵ Williams *Income Tax and Capital Gains Tax In South Africa Law and Practice* 337

¹⁹⁶ Silke *Silke on South African Income Tax* volume 1 (2003) 7-72

¹⁹⁷ *ITC 1490* 53 SATC 108

¹⁹⁸ *ITC 1212* 36 SATC 108

¹⁹⁹ Jacobson *The tax treatment of illegal transactions* (1986) 25

gratification in order to influence another to act in a manner that amounts to the abuse of a position of authority, a breach of trust, violation of a duty or a set of rules, in order to achieve an unjustified result. This includes the giving of a gratification to or acceptance by persons occupying public office, parties in an employment relationship and a list of other activities, including sporting events and gambling. The prohibition in section 23(o) would not, therefore, relate directly to the offences forming the basis of this research, except with regard to fines or penalties incurred in respect of the illegal activities, which would not be deductible. It is also likely that persons engaging in illegal activities would pay bribes or gratifications to persons in authority to promote the success of their activities. Such payments would be disallowed in terms of section 23(o)²⁰⁰

Jacobson²⁰¹, on the issue of the deductibility of fines, proposes the consideration of businesses that cannot operate legally and which therefore incur fines as part of carrying on trade. Jacobson also argues that such traders know that if they conduct their business they will incur fines, but if they do not they will not earn income; therefore such fines are incurred in the production of income and a deduction must be granted, as there can be no public policy bar to deductibility²⁰². In such a situation it can be inferred that incurring fines is a necessary concomitant of the trade and they are necessary for carrying on such a trade, thus they are deductible. Section 23(o) has, however, settled the matter and, irrespective of the close connection of certain fines with the income-earning activities of the taxpayer, they will not be deductible.

The policy which justifies the inclusion of illegal proceeds in gross income is one of revenue collection; the revenue laws place all taxpayers on an equal footing, as far as the taxability of their receipts goes²⁰³. In other words, the Income Tax Act provides for the

²⁰⁰ *Income Tax Act 58 of 1962*

²⁰¹ Jacobson *The tax treatment of illegal transactions* (1986) 21

²⁰² Jacobson *The tax treatment of illegal transactions* (1986) 24

²⁰³ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

taxation of taxpayers on all their receipts and accruals, irrespective of their source. "It follows, then, that the policy underlying the deductibility of expenditure should also be one which seeks to place honest and dishonest taxpayers on an equal footing"²⁰⁴. If the honest taxpayer cannot be discriminated against through the delinquent taxpayer being allowed to escape the inclusion of his receipts in gross income, then the delinquent taxpayer should not be discriminated against through the honest taxpayer being allowed deductions to which he (the delinquent taxpayer) is not entitled²⁰⁵. In *ITC 1199*²⁰⁶ Margo J stated *obiter* that since income from unlawful trading is assessable to tax, expenditure in the production thereof is deductible. There should be no moral interpretation or consideration of public policy in interpreting the provisions of the Income Tax Act²⁰⁷. If an amount falls within the ambit of the Act it must be taxed and if on the other hand an amount meets the deductibility requirements it must be deductible²⁰⁸.

3.2.7 DEDUCTIBILITY OF OTHER EXPENSES

Persons involved in the illegal activities of prostitution, fraud or theft may incur a number of other expenses in relation to their illegal trades that would not qualify for deduction in terms of the general deduction formula. Capital expenses were briefly referred to above and, provided expenses relating to an illegal business are deductible in principle, the cost of any equipment used in producing the income may qualify for a wear-and-tear allowance in terms of section 11(e) of the Income Tax Act. Repairs to such equipment may qualify for deduction in terms of section 11(d).

Another type of expense that persons involved in illegal activities would, sooner or later, have to incur is legal expenses. These expenses may not meet the requirements of the

²⁰⁴ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

²⁰⁵ Monteiro and Bonthuys 'Sex for sale: the prostitute as businesswoman' (2007) [On line]. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>. [Accessed 20/06/2007]

²⁰⁶ *ITC 1199* 36 SATC 16 at 19

²⁰⁷ Jacobson *The tax treatment of illegal transactions* (1986) 25

²⁰⁸ Jacobson *The tax treatment of illegal transactions* (1986) 25

general deduction formula, but may be deductible in terms of section 11(c) of the Income Tax Act. This section provides for the deduction of any legal expenses (of the nature described in the section) “actually incurred during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade . . .”. The expenses need not, therefore, be incurred “in the production of income”, but by reason of the ordinary business operations. Though not deductible in terms of section 11(a) of the Income Tax Act, the expenses would qualify in terms of section 11(c), unless the legal expenses are of a capital nature, which are also excluded in terms of the paragraph. Legal expenses incurred in relation to the offences associated with illegal activities are closely connected with the “trade” being carried on illegally – being “by reason of the ordinary operations”. These legal expenses should comply with section 11(c)²⁰⁹, unless they are of a capital nature. In *Smith v SIR*²¹⁰, a case concerning the capital or revenue nature of legal expenses incurred by a chartered accountant in defending himself against charges of fraud and contraventions of the Companies Act and the Insolvency Act, it was held that “the dominant purpose would have been to prevent a conviction which would in all probability have entailed a term of imprisonment and certainly lasting disgrace to him as a man . . . I am unable to regard freedom from imprisonment and from such disgrace as capital assets in the ordinary sense . . . [and] I am of the opinion that the appellant’s expenditure in defending himself against the charges preferred against him is not of a capital nature”. Persons involved in prostitution or profiting from the activities of prostitution, who incur legal costs to prevent imprisonment and ensure their the ability to continue earning income, would (all else being equal) be able to deduct the costs in terms of section 11(c)²¹¹ as non-capital expenses closely connected with their normal business activities.

²⁰⁹ *Income Tax Act 58 of 1962*

²¹⁰ *Smith v CIR 30 SATC 35 at 41*

²¹¹ *Income Tax Act 58 of 1962*

3.3 CONCLUSION

This chapter discussed the general deduction formula and related case law in principle and in particular in relation to income from illegal activities. The principle that has been established is that no distinction is made between income obtained legally or illegally. The principle may, however, be different when it comes to the deductibility of expenditure incurred in the production of legal and illegal income. In general, considerations of public policy may prevent the deduction of expenses relating to an illegal activity. Although the Income Tax Act does not specifically refer to illegal activities, it is fairly clear that prostitution and the direct and indirect earnings from prostitution and the income from fraud or theft carried on regularly and in a business-like manner, would constitute a "trade", as defined. It also appears that the expenses relating to these illegal activities would qualify for deduction in terms of the general deduction formula, provided they are of a non-capital nature and provided they are *bona fide* incurred in producing the income or are closely connected with the production of the income. Other deductions may be available in relation to the trade, for example, legal expenses, wear-and-tear allowances on capital equipment or its repair. In the case of theft or fraud, the deduction of compensation payable to the victims of the crimes may present a problem as these expenses would not, it is submitted, be incurred in the production of income. The law is clear on one aspect, however, and that is that the deduction of fines, penalties and expenses relating to corrupt activities²¹² is prohibited.

²¹² An activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004

CHAPTER 4: THE UNITED STATES OF AMERICA AND THE UNITED KINGDOM

4.1 INTRODUCTION

Up to this point, the thesis has dealt with the legal position under South African law, of persons deriving income from illegal activities. This chapter focuses on a brief comparison between the tax systems of the United Kingdom, United States of America and South Africa in relation to their treatment of income from illegal activities. The aim is to compare and contrast the three tax systems, in order to address the third objective of the research.

4.2 THE UNITED STATES OF AMERICA

The Sixteenth Amendment to the Constitution of the United States of America (referred to as the United States) provides Congress with the power to levy and collect taxes on income from whatever source it is derived²¹³. Section 61 of the Internal Revenue Code defines the term "gross income" to include all income from whatever source it is derived, except as otherwise provided. As a result of this broad definition, gross income includes embezzled funds, income from illegal activities and gambling winnings, among numerous other items. The United States tax system has similarities to the South African tax system. In South Africa the legitimacy or legality of the source of income appears to be irrelevant. If the amount in question is gross income in terms of the definition it will be taxable. In a United States case of *United States v Sullivan*²¹⁴ it was held that the mere fact that income is from an illegal source or activity does not exempt such a receipt from tax. As a result, in *Rutkin v United States*²¹⁵, where the taxpayer obtained the income in question by threatening the victim and his family, the court held that failure to disclose this income amounted to tax evasion.

²¹³ Sixth Amendment to the United States Constitution

²¹⁴ *United States v Sullivan*, 274 U.S. 259 (1927)

²¹⁵ *Rutkin v United States*, 72 Sup Ct 571 (1952)

The rationale for taxing wrongdoers on income from illegal activities is not to allow wrongdoers to benefit from their misdeeds without paying what is due to the *fiscus*²¹⁶.

4.2.1 RECEIPTS

The United States used to have a claim of right doctrine which held that income derived from illegal activities cannot constitute income for tax purposes because the taxpayer has no claim of right to the income and is under an obligation to return the proceeds²¹⁷. Under this regime a “taxable gain” referred to income upon which the taxpayer had a claim of right in the absence of an unconditional duty to return such gain²¹⁸. In the case of *James v United States*²¹⁹, the claim of right doctrine was rejected and the court held that courts in cases that involve the taxability of illegal income should apply the economic benefit approach. The economic benefit doctrine asks the question whether or not the taxpayer has control over the income from illegal activities, in that it can be reasonably held that such taxpayer derives a readily realisable benefit from it²²⁰. A thief steals to benefit himself or herself and thus derives a benefit from the stolen property either from its use or realisation. The court, in *James v United States*, held further that the rationale for the adoption of the economic benefit doctrine was to stop the injustice brought about by the claim of right doctrine which relieves thieves of their duty to support the *fiscus* by paying tax, while honest taxpayers are taxed on all their income.

The tax system of the United States has moved away from a regime of only taxing the rightful owners of income, to a regime that taxes the benefit derived by the taxpayer or by the person dealing with the asset or the money in the way that an owner would. The new regime abolished the notion of taxing income from legitimate sources only and thus

²¹⁶ Colliton ‘The Tax Treatment of Criminal and Disapproved Payments’ (1989) 9 *Virginia Tax Review* 273 at 278

²¹⁷ Monterio ‘Money doesn't smell’ (2005) *Without Prejudice* 5 (7) at 12

²¹⁸ *Commissioner v Willcox*, 327 U.S. 404 (1946)

²¹⁹ *James v United States* 366 US 213 (1961)

²²⁰ *James v United States* 366 US 213 (1961) 219

income from both legal and illegal sources is subject to tax. In other words the system does not consider the *right* to income but the *benefit* derived from it.

4.2.2 DEDUCTIONS

The mandate to levy tax is provided for in the Constitution but the Constitution does not make any provision for the granting of deductions²²¹. Deductions are thus creatures of statute and a taxpayer has no intrinsic right to them. Congress thus has the power, but not the obligation, to enact laws that allow for deductions²²². In *New Colonial Ice Company v. Helvering*²²³, the court ruled that the tax deductibility of expenses depends merely on legislative grace, which means that all exclusions from gross income and every deduction can be viewed as gifts from Congress.

The tax system in the United States levies tax on net income rather than gross income. Gross income is made up of all receipts and accruals and net income, on the other hand, is made up of gross income minus business losses and non-business losses incurred in the production of income. Government and the courts have narrowed the generally accepted meaning of the phrase business expenses as used in the deductions section in order that tax deduction consequences might not frustrate national and State policy dealing with acceptable conduct²²⁴. Although revenue laws allow for the deduction of certain expenses incurred in the production of income, other deductions are disallowed on public policy grounds²²⁵. An illegal enterprise may deduct lawful expenses and salaries involved in the actual earning of income²²⁶. For an expense to be deductible it does not only need to be an economic cost of earning income but it must not be against public policy²²⁷. The denial of deductions for expenditure incurred in the production of illegal income developed from

²²¹ Sharp 'Tax accounting for illegal activities' (2003) *The National Public Accountant* 1

²²² Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 280

²²³ *New Colonial Ice Company v Helvering* 292 U.S. 435 (1934)

²²⁴ *Commissioner v Heininger* 320 U.S. 476 (1943)

²²⁵ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 273

²²⁶ *Cohen v Commissioner* 176 F.2d 394 (1947)

²²⁷ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (Fall, 1989) 9 *Virginia Tax Review* 273 at 274

case law and the courts held that the deductibility of such expenditure would frustrate public policy²²⁸. Thus, the denial of deductions on the grounds that they are inconsistent with public policy leads to taxpayers paying tax on their receipts or on their gross income and not their net income by not being granted the deduction of expenses incurred in earning such receipts. The denial of a deduction on the grounds of public policy also leads to double punishment in that, by denying a deduction, tax law would be punishing a taxpayer regardless of whether he has already been punished under any other law²²⁹.

Colliton²³⁰ argues that the denial of deductions and the taxation of proceeds leads to inequitable results and that tax law is not the correct medium to be used to punish wrongdoers. In order to maintain consistency throughout the system, it would be preferable to regard tax as a mechanism of revenue collection both for the purposes of gross income and deductions²³¹. Public policy has been compared to an unruly horse which, when once one gets astride it, he or she never knows where it will carry him or her²³². Public policy is constantly changing and thus relying on it will lead to uncertainty in tax law and on the implications of certain conduct, because it changes with community values and morals.

In *Sam Mesi*²³³ it was held that salaries paid to employees by an employer engaged in illegal activities were not allowable business expense deductions. Denying a delinquent taxpayer his deductions is based on the view of taxation as moral barometer, while allowing such deductions entails a view of taxation as a mechanism for revenue collection,

²²⁸ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 275

²²⁹ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 280

²³⁰ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (Fall, 1989) 9 *Virginia Tax Review* 273 at 278

²³¹ Carrie F Keller 'The Implications of I R C s 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers' (Winter, 2003) 47 *Saint Louis University Law Journal* 157 at 163.

²³² *Dixie Machine Welding and Metal Works, Inc v United States* 315 F.2d 439 (5th Cir. 1963)

²³³ *Sam Mesi* 25 T.C. 513 (1955)

dependent on accurate methods of computation²³⁴. In *Commissioner v Sullivan*²³⁵, the court allowed the deduction of rent and wages paid by an illegal bookmaking operation. Some courts denied deductions where the payments were not ordinary or necessary, without considering public policy²³⁶. In *Tank Truck Rentals, Inc. v. Commissioner*²³⁷, for example, the courts held that the payment of an expense which is against public policy does not represent a necessary expense.

As a result of the problems inherent in relying on public policy for the denial of deductions, the Congress endeavoured to codify the public policy set by judicial precedent so that it could form the basis of allowing and disallowing deductions²³⁸. The statutory provision for the deduction of expenditure incurred in the production of income is found in section 162 of the Internal Revenue Code (to be referred to as the IRC). Section 162(a) of the IRC provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business. The section was enacted to provide clearly defined grounds for disallowance as public policy does not always justify a denial of a deduction. Thus section 162 denies a business expense deduction only if the expense falls under one of the specific public policy denial sections²³⁹. Deduction of the following expenses is denied:

- Illegal bribes, kickbacks and other payments²⁴⁰
 - (1) Illegal payments to government officials or employees:

No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback

²³⁴ Carrie F Keller 'The Implications of I R C s 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers' (Winter, 2003) 47 *Saint Louis University Law Journal* 157 at 163.

²³⁵ *Commissioner v Sullivan* 356 U.S. 30 (1958)

²³⁶ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 276

²³⁷ *Tank Truck Rentals Inc. v Commissioner* 356 US. 30 (1958)

²³⁸ Sharp 'Tax accounting for illegal activities' (2003) *The National Public Accountant* 1

²³⁹ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 277

²⁴⁰ Subsections 162 (c) of the IRC

or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the foreign Corrupt Practices Act of 1977. . . .

(2) Other illegal payments

No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State-law is generally enforced), which subjects the payor to a criminal penalty or the loss of licence or privilege to engage in trade or business.

- Denial of deduction for certain lobbying and political expenditures²⁴¹

(1) In general, no deduction shall be allowed under subsection (a) for any amount paid or incurred in connection with –

- (A) influencing legislation
- (B) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office,
- (C) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or
- (D) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.

It would appear that these public policy denial provisions are similar to the prohibition in section 23(o) of the South African Income Tax Act and do not relate to expenditure incurred in respect of the illegal activities addressed in the present research, other than expenditure denied in terms of section 23(o)²⁴².

4.2.3 ILLEGAL EXPENDITURE

In *Tank Truck Rentals Inc. v Commissioner*²⁴³, the taxpayer intentionally violated the weight limitations that applied to the trucking services and incurred a fine. In denying the deduction of the fine the court held that allowance of such fines as a deduction would encourage continued violation of state law and also because such a fine was not necessary for the operation of the trucking business²⁴⁴. The IRC provides for the disallowance of a

²⁴¹ Subsection 162(e) of the IRC

²⁴² Income Tax Act, 58 of 1962

²⁴³ *Tank Truck Rentals Inc. v Commissioner* 356 US. 30 (1958)

²⁴⁴ *Tank Truck Rentals Inc. v Commissioner* 356 US. 30 (1958) at 35

deduction where the expenditure in question relates to a fine or a penalty²⁴⁵. It is argued that allowing a deduction for fines imposed for the violation of laws and regulations would lessen the intended impact of the penalty, as the government would be indirectly subsidising a portion of the guilty taxpayer's transgression²⁴⁶. For a fine to fall within the ambit of the prohibition, the fine must have been imposed upon and paid by the taxpayer attempting to deduct it²⁴⁷. The effect of this section is that a taxpayer who has been fined endures further punishment from tax law by being denied a deduction. It was held in *Commissioner v Heininger*²⁴⁸ that it is not the purpose of tax law to penalise illegal business by taxing gross income instead of net income. Nevertheless, if a taxpayer violates a law and a fine is imposed, that fine is not deductible even if such a violation occurred in the process of furtherance of the taxpayer's business or trade.

Operational expenses inherent in all commercial enterprises have generally been allowed as deductions from the gross income of an illegal business²⁴⁹. The words "ordinary and necessary" refer to those expenses which are an integral part of a business, whether it is lawful or unlawful²⁵⁰. In *Reffet v Commissioner*²⁵¹ a deduction for payments made to witnesses for their testimonies in a lawsuit was denied on the grounds that such payments were not ordinary expenses. In *G.A. Comeaux*²⁵² a deduction for salaries was allowed and emphasis was placed on the fact that these were expenses incurred in earning the income reported by the taxpayer. In *Anthony Cornero Stralla*²⁵³ it was held that expenses expended in the actual production of income were recognized as deductible. In *Pittsburgh Milk Co*²⁵⁴ the taxpayer company was in the business of retail and wholesale distribution

²⁴⁵ Section 162(f) of the IRC

²⁴⁶ Sharp 'Tax accounting for illegal activities' (2003) *The National Public Accountant* 1

²⁴⁷ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 282

²⁴⁸ *Commissioner v Heininger* 320 U.S. 467, 474 (1943)

²⁴⁹ Landis Income "Tax Deductibility of Wages Paid by Employers Engaged in Illegal Activities, Bookmaking" (1956) *California Law Review*, 44 (4): 797-800 at 798

²⁵⁰ *Commissioner v Doyle* 231 F.2d 635 (7th Cir. 1956)

²⁵¹ *Reffet v Commissioner* 39 TC 869 (1963)

²⁵² *G.A. Comeaux* 10 T.C. 201 (1948) at 207

²⁵³ *Anthony Cornero Stralla* 9 TC 801 821 (1947)

²⁵⁴ *Pittsburgh Milk Co*, 26 TC 707, 717 (1956)

of milk. A price floor was set for the sale of milk and the taxpayer was illegally giving rebates to its customers in terms of contracts concluded between the taxpayer and its customers. The deduction from the gross income of the taxpayer of the amount of the rebates was disallowed by the Commissioner. The court held that a seller's illegal rebate was an exclusion, rather than a deduction item, and therefore necessarily outside the scope of the public policy doctrine. The law allows the deduction of a legitimate expense incurred by a taxpayer carrying on an illegal business²⁵⁵.

Case law indicates differing treatment of expenditure by taxpayers involved in illegal activities. The *Tank Truck Rentals* case held that fines are not deductible while the *Sullivan* and the *Sam Mesi* cases held that other expenses incurred in the production of income generated in an illegal manner are deductible. This means that taxpayers may be involved in illegal activities and the expenditure of one taxpayer will be allowed as a deduction and the expenditure of another taxpayer will be denied. Case law further implies that for expenditure to be deductible it must be ordinary or necessary for carrying on such a trade or business. Thieves and the perpetrators of fraud cannot efficiently and effectively earn their income if they do not use equipment and labour in performing their duties. This means that, as the law stands, thieves can deduct such expenditure as it is necessary in order for them to earn their income. The denial of such expenditure leads to arbitrary results because paying tax on the gross income means an additional punishment to taxpayers who have been punished under other laws, while other equally guilty taxpayers escape with no tax punishment²⁵⁶.

Colliton²⁵⁷ argues that the denial of a business expense deduction is neither an appropriate nor an effective way to punish wrongdoers and it is not consistent with the general purpose and structure of tax law. The sole purpose of tax law is to collect revenue and provide

²⁵⁵ DeMattei "The Use of Taxation to Control Organized Crime"(1951) *California Law Review*, 39 (2): 226-234 228

²⁵⁶ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 278

²⁵⁷ Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 *Virginia Tax Review* 273 at 278

finance for government's budget. It is thus not for tax law to punish taxpayers for their bad behaviour that is not tax-related.

It would appear that all ordinary and necessary expenses paid or incurred during a tax year in carrying on an illegal trade or business would be deductible, other than those specifically denied under the public policy denial sections. This provides more certainty in relation to deductions, than the South African law provides.

4.3 THE UNITED KINGDOM

In an old English case of *Hayes v Duggan*²⁵⁸ it was held that profits derived from running a sweepstake, being profits derived from a criminal enterprise, are not assessable to tax. The rationale for such a decision was said to be based on the construction that the State should not be seen to be benefiting from what it prohibits²⁵⁹. Another reason for the non-taxability of proceeds from illegal activities is because of the moral or ethical interpretation used by courts that caused illegal activities to fall outside the definition of trade²⁶⁰.

The approach to taxation of income from illegal activities changed to one where an amount is taxed only if it is derived from a trade. Once it has been established that an activity constitutes a trade, profits obtained from such a trade are taxable²⁶¹. Where a taxpayer systematically engages in an illegal activity and the elements of a business are present, such as repetition, regularity, view to a profit and organisation, the proceeds from the activity have an income character²⁶². In other words once the character of a business has been ascertained as being of the nature of trade, the person who carries it on cannot found upon elements of illegality to avoid the tax²⁶³.

²⁵⁸ *Hayes v Duggan* [1929] 1 KB 752 at 758

²⁵⁹ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752 at 758

²⁶⁰ Jacobson *The tax treatment of illegal transactions* (1986) 5

²⁶¹ Jacobson *The tax treatment of illegal transactions* (1986) 4

²⁶² It's a fair cop [On line]. Available:

<http://www.taxation.co.uk/Articles/2005/04/07/49845/It's+a+fair+cop.htm>

²⁶³ *Minister of Finance v Smith* [1927] AC 193

The courts in the United Kingdom distinguish between two types of trade: legal and illegal trade. They also hold that proceeds will be taxed provided they arise from a trade, whether legal or illegal²⁶⁴. Receipts from a systematic activity, where the elements of a business are present, are income for tax purposes irrespective of whether the activities are legal or illegal²⁶⁵. The fact that the trade involves contractually unenforceable illegal acts does not, of itself, mean that the trading operations were beyond assessment to income tax²⁶⁶.

In *Lindsay, Woodward and Hiscox v CIR*²⁶⁷ it was held that the burglar and the swindler, who carry on a trade or business for profit, are as liable for tax as an honest business man. In *Mann v Nash*²⁶⁸, the appellant was an amusement caterer hiring out fruit machines, the use of which was at that time illegal. The question to be decided on by the court was whether the profits from these machines were subject to tax and the court held that there is no reason why receipts from letting machines in a commercial way with the aim of making a profit will not be a trade with taxable profits. In this case, the issue of the State benefiting from illegal activities was addressed and it was further held that the State was not coming forward to take a share in the profits of unlawful gaming or condoning this practice, but it was merely attempting to tax individuals who receive income²⁶⁹. Once the character of a business has been ascertained as being of the nature of trade, the person carrying on such a trade cannot avoid tax by arguing that the trade is illegal²⁷⁰.

In *CIR v Aken*²⁷¹ the Commissioner sought to tax income earned through prostitution. The Commissioner in this case was able to prove that a trade was being carried on. It was

²⁶⁴ *CIR v Aken* 63 TC 395 413G

²⁶⁵ It's a fair cop [On line].*Available:

<http://www.taxation.co.uk/Articles/2005/04/07/49845/It's+a+fair+cop.htm>

²⁶⁶ *Lindsay, Woodward & Hiscox v CIR* 1933 SC 33

²⁶⁷ *Lindsay, Woodward & Hiscox v CIR* 1933 SC 33

²⁶⁸ *Mann v Nash (HM Inspector of Taxes)* [1932] 1 KB 752 at 758

²⁶⁹ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752 at 758

²⁷⁰ *Minister of Finance v Smith* [1927] AC 193 (PC) at 197

²⁷¹ *CIR v Aken* 63 TC 395

further held that if the activity is a trade, it is irrelevant for taxation purposes that it is illegal²⁷².

Jacobson²⁷³ argues that if tax is chargeable when a legal trade is being carried on in an illegal manner or illegal transactions are entered into, then the same principles of taxation should apply where the trade is wholly illegal.

4.3.1 DEDUCTIONS

The respondent in *CIR v Alexander von Glehn and Co Ltd*²⁷⁴ was sued for penalties in respect of alleged infringements of an Act in the course of its trade. The court held that the penalty and costs were not permissible deductions in arriving at the profits of the company's trade. In *Herald and Weekly Times Ltd v FC of T*²⁷⁵ the taxpayer was sued for the publication of a defamatory statement in its publications. When the amount of damages and the legal costs were claimed as a deduction the court held that such expenditure was wholly and exclusively laid out and expended for the production of assessable income and was therefore deductible. Even though the taxpayer in the *Herald and Weekly Times* case could have continued to produce income by publishing non-defamatory statements the court still allowed the deduction. It is submitted that incurring damages and legal costs is closely linked with the type of trade the taxpayer carried on and not really a penalty in the normal sense. The Telegraph²⁷⁶ reported that a Dutch court allowed a bank robber to claim the cost of a pistol used during a robbery. The court in this case allowed the robber to deduct from his gross income the cost of the pistol on the grounds that criminal acts can be compared to normal business acts where money is spent in a quest to make more. In other words in this case the court did not look at the illegality of the act but looked at the expenditure incurred in the furtherance of the robber's trade.

²⁷² *CIR v Aken* 63 TC 395 405 F-H

²⁷³ Jacobson *The tax treatment of illegal transactions* (1986) 3

²⁷⁴ *CIR v Alexander von Glehn and Co Ltd* 12 TC 232 (CA)

²⁷⁵ *Herald and Weekly Times Ltd v FC of T* 48 CLR 113

²⁷⁶ Rennie 'making crime pay' 2005 *The Telegraph* 27 January

4.3.2 ILLEGALITY IN A LEGAL TRADE

If, in the course of trading, a taxpayer breaches the law and is fined, the fine is not connected to his business but such fine is imposed on the taxpayer personally²⁷⁷. In *CIR v E C Warnes & Co Ltd*²⁷⁸, it was held that a penal liability cannot be regarded as expenditure arising out of a trade as a loss connected to trade must be contemplatable and must be in the nature of a commercial loss. Although prostitution is legal in the United Kingdom, prostitutes may incur illegal expenses when carrying on their trade. In *CIR v Aken* it was held that even though a prostitute is not legally allowed to incur expenditure on advertising, the rental of premises, employing people, forming a partnership or a company, the illegality of the activities which constitute a trade will not prevent it from being a trade. It would appear that such expenses, although incurred for illegal purposes, would qualify for deduction.

4.4 CONCLUSION

The taxing statute in the United States empowers the Commissioner to levy tax on income received by a taxpayer and does not make any provision for the exclusion of income from illegal activities. The law does allow deductions for expenditure incurred in the production of income but only if such expenditure is necessary. Expenditure on fines and penalties is, however, not deductible.

In the United Kingdom, the law provides for the taxation of all income derived from a trade, whether the trade is legal or illegal. Deductions are only allowed for expenditure that is legitimate, meaning expenditure inherent in that particular trade. The United Kingdom also does not allow for the deduction of penalties and fines.

While there are similarities between the taxation of income from illegal activities in South Africa, the United States and the United Kingdom, there appears to be more certainty in

²⁷⁷ *CIR v Alexander von Glehn and Co Ltd* 12 TC 232 (CA) at 238

²⁷⁸ *CIR v E C Warnes & Co Ltd* 12 TC 227 (KB) 231

the United States and the United Kingdom in relation to the deductibility of expenses incurred in earning the illegal income.

5. CONCLUSION

5.1 TAXING ILLEGAL ACTIVITIES IN SOUTH AFRICA

This thesis has discussed the tax implications of receipts and accruals, as well as expenses, relating to illegal activities, with special emphasis on fraud, theft and prostitution. Income can be derived in two ways: through legal channels and through illegal channels. Regardless of how it was derived income should all be placed on an equal footing. Everyone should make their fair contribution to the *fiscus* by contributing according to what they have received or what accrued to them. The problem faced by the taxing authorities is the integrity of such systems in the public eye. If income from illegal activities is taxed, the public may not see that as the equal treatment of all income, but may interpret it as government condoning and benefiting from unlawful activities. The *fiscus* benefits from taxing crime and there is a pressing need for revenue in South Africa. Not taxing income from illegal activities will mean less money for the *fiscus*. On the other hand, if income from illegal activities is not taxed it would appear that criminals are above the law. If delinquent taxpayers were not taxed this would defeat the attempts to uproot crime, as this would amount to granting permission to set up illegal trades or income-earning ventures so as to earn tax-free income²⁷⁹. Whether the same rationale should apply to the granting of deductions, is questionable.

In South Africa, the Income Tax Act defines gross income as amounts, in cash or otherwise, received by or accrued to or in favour of the taxpayer. This definition does not make any distinction between the legality and illegality of the source of such income. The Act merely requires the taxation of all income received by or accrued to a taxpayer. The first objective of the research was to analyze the taxability of receipts and accruals derived from illegal activities, including the timing of a receipt and therefore the year of assessment in which the tax will be levied, given the remedies available to the victim of the crime. A thief, the perpetrator of fraud and a prostitute are all involved in illegal

²⁷⁹ *Minister of Finance v Smith* [1927] AC 193 (PC) at 197

activities and in terms of the gross income definition what they earn is included in gross income.

The question whether or not income from illegal activities is subject to tax was settled in 1918 by the decision in *CIR v Delagoa Bay Cigarette Co*²⁸⁰. Bristowe, J stated that:

I do not think it is material for the purposes of this case whether the business carried on by the company is legal or illegal. . . . The source of the income is immaterial.

Income received by or accrued to prostitutes, thieves and the perpetrators of fraud are subject to taxation, provided their income complies with the other provisions of the gross income definition.

Before the decision in *MP Finance Group CC (in liquidation) v C:SARS*²⁸¹ settled the question, the courts had two choices in relation to including gains from theft or fraud in gross income: either to ignore the general principle that a potential obligation to repay the proceeds of theft or fraud or pay compensation to the victims is a condition which prevents the amounts from being received in the year of assessment in which the crime is committed, or to tax net income on the basis of readily realizable economic value²⁸². In cases of theft and fraud the thieves or persons committing fraud do not acquire ownership of income or property received through their illegal trade. They can be sued and ordered to pay back all that was taken without the consent of the owner. This chance of being sued or ordered to restore the status *quo* could be viewed as a condition for the accrual of income so received. In terms of South African law, income accrues to a taxpayer when all conditions have been fulfilled. If a condition still applies, such income cannot accrue.

The gross income definition includes in its scope “amounts, in cash or otherwise”, therefore encompassing both amounts in the form of cash and the value of assets. South African law provides for the taxation of an amount on either receipt or accrual, whichever

²⁸⁰ *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391, 32 SATC 47

²⁸¹ *MP Finance Group CC (in liquidation) v C:SARS* 69 SATC 141

²⁸² Monterio 'Money doesn't smell' (2005) *Without Prejudice* 5 (7) at 12-13.

occurs first. In cases of theft and fraud, thieves and persons committing fraud actually receive the cash or stolen goods. The decision in the *MP Finance Group CC* established the principle that the fact that such income may not accrue to taxpayers because it is subject to a condition, does not prevent the taxation of such income when it is received. The chance of being ordered to restore the status *quo* does not, therefore, prevent the taxation of the proceeds. If income was received for one's own benefit, such income is assessable to tax.

Tax is not levied directly on gross income. A taxpayer must exclude exempt income and is allowed certain deductions in determining his or her tax liability. The second objective of the research was to analyse the deductibility of expenses incurred in the production of income from illegal activities. The preamble to section 11 and section 11(a) of the Income Tax Act, together with section 23(f) and (g) (the general deduction formula), provide for the granting of deductions to taxpayers who are carrying on a trade. The definition of "trade" in section 1 of the Income Tax Act does not refer to legality or morality. Thus, as the South African law stands, one does not have to be carrying on a legal or legitimate business to be carrying on a trade for tax purposes. Even though theft, fraud and prostitution are criminal activities, the facts of each case will determine whether these criminal activities constitute a trade. It is submitted that this reflects the law as it is.

Section 11(a) provides certain requirements for expenditure to be deductible. The expenditure of taxpayers involved in criminal activities may include various types of expenditure, including the purchase of capital equipment, repairs to such equipment, the payment of salaries, legal expenses and others. To qualify for deduction, the expenditure in question must, in addition to satisfying the "trade" requirement, must be incurred "in the production of income", that is, it must be so closely linked to the act giving rise to it that it can be regarded as part of the cost of performing it (*Port Elizabeth Electric Tramways Company Ltd v CIR*²⁸³). In *Joffe and Co (Pty) Ltd v CIR*²⁸⁴ the court referred to

²⁸³ *Port Elizabeth Electric Tramways Company Ltd v CIR* 1936 CPD 241, 8 SATC 13

²⁸⁴ *Joffe and Co (Pty) Ltd v CIR* 13 SATC 354

expenses incurred *bona fide* for the purposes of trade. If, therefore, a criminal is carrying on a trade and incurs expenditure which meets the requirements of “in the production of income”, as well as the other requirements of section 11(a), the expenditure should be deductible. Expenditure of a capital nature would, however, not be deductible in terms of section 11(a), but may qualify in terms of other subsections of section 11.

Being involved in illegal activities also carries the risk of being caught and thus fines (and imprisonment) can be held to be inherent in such trades. The Income Tax Act, in section 23(o), specifically prohibits the deduction of fines and penalties. In other words the penalties imposed on a perpetrator of a crime, instead of imprisonment, would not be deductible even though they were incurred as a result of the production of income.

In the case of fraud or theft, the stolen items to be returned to the victim or the compensation to be paid, depends on a case being brought against the taxpayer. This “amount” can therefore only be incurred in the year in which the court order to return the stolen goods or to pay compensation is granted (*CIR v Golden Dumps (Pty) Ltd*²⁸⁵), or when the person voluntarily does so. If income was received by the taxpayer, he or she will be liable for tax as it formed part of his or her gross income. When the order to return the stolen property or to pay compensation is granted, the amount does not appear to meet the requirement of “in the production of income” in section 11(a) of the Act (*Port Elizabeth Electric Tramways Company Ltd v CIR*²⁸⁶). In other words, when repaying an amount there is only an outflow of what was received earlier and there is no further inflow of any income as a result of the payment. Failure to meet any of the requirements in section 11(a), including the requirement that expenses must be incurred “in the production of income” leads to the denial of a deduction.

²⁸⁵ *CIR v Golden Dumps (Pty) Ltd*, 55 SATC 198

²⁸⁶ *Port Elizabeth Electric Tramways Company Ltd v CIR* 1936 CPD 241, 8 SATC 13

5.2 THE UNITED STATES OF AMERICA

The final objective of the research was to present a brief comparison between the tax on illegal activities as levied in the United States, the United Kingdom and South Africa. In the United States, gross income for taxation purposes refers to all income received whatever its source. The taxing statute empowers the Commissioner of Taxes to levy tax on all income received by taxpayers regardless of its source. The mere fact that income is from an illegal source does not exempt such a receipt from tax. Criminals are taxed so that they cannot derive the full benefit of their misdeeds without paying what is due to the *fiscus*.

Initially taxpayers who had a claim of right to the income they received in that particular year of assessment were taxed on it. United States law then recognised the injustice brought about by the claim of right doctrine and an economic benefit doctrine was adopted. For an amount to be taxed the taxpayer must derive an economic benefit from such income.

The Constitution of the United States provides for the levy of tax on all income but does not make any provision for the allowance of deductions. It was thus left to the judiciary to decide on the deductions to be allowed and for many years this decision was taken on public policy considerations. In other words, a deduction was only allowed if it did not contravene public policy. Under this regime, expenditure incurred in the production of illegal income was not allowed as a deduction because allowing it would be inconsistent with public policy.

Relying on public policy lead to inconsistency and uncertainty in law and Congress decided to enact a deduction section to avoid having to rely directly on public policy. Section 162(a) of the Internal Revenue Code provides for the deduction of all ordinary and necessary expenses incurred in carrying on a trade. All ordinary expenses incurred, whether lawful or unlawful, are allowed as deductions as they are inherent in all commercial enterprises. In other words the law allows the deduction of legitimate

expenses incurred in carrying on an illegal trade. It is thus submitted that expenditure on equipment and salaries are deductible even if the taxpayer is carrying on an illegal trade. Fines and penalties on the other hand are not deductible, even if they were incurred in the production of income. This disallowance is specifically provided for in the Internal Revenue Code. The situation in the United States with regard to the deduction of expenses incurred in carrying on an illegal trade is more certain than it is in South Africa.

5.3 THE UNITED KINGDOM

Kennedy CJ in *Hayes v Duggan*²⁸⁷ posed the question whether the executive would keep its revenue eye open and vigilant and its eye of justice closed to crime, if the crime is untaxed. Thus in the United Kingdom tax is levied on all income derived from a trade. A trade can be legal or illegal. The rationale for taxing income from an illegal trade is that there is no reason why a receipt from any commercial act done with the object of making a profit should not be viewed as income from trade. By taxing income from an illegal trade the Commissioner is not condoning the illegal trade but is taxing those who receive income. Fines are not deductible as they are viewed as not being connected to the taxpayer's business but are imposed on the taxpayer in his or her personal capacity. Other expenses incurred in the furtherance of an illegal trade are, however, deductible.

5.4 THE CONSTITUTIONALITY OF TAX DISCLOSURES – AN OPPORTUNITY FOR FURTHER RESEARCH

The constitutionality of the requirement to disclose information to the Revenue Authorities, without providing for the rights of the taxpayer making the disclosure, is a topic for further research. The following discussion provides the rationale for this statement.

For tax to be collected from taxpayers, the Commissioner issues income tax returns and a guide to help taxpayers when filling in tax returns. The guide, entitled *Income Tax and the*

²⁸⁷ *Hayes v Duggan* [1929] 1 KB 752

Individual 2006/2007, states that every individual who receives income in excess of a specified amount is liable for income tax²⁸⁸. This guide also includes a list of different types of income on which an individual can be taxed: all income from employment, income from business or trade, investment income, a pension, capital gains, etc²⁸⁹. It further specifies that individuals who receive income in excess of a certain amount and income from their own businesses must complete and submit a tax return to the South African Revenue Services²⁹⁰. It is made clear that an individual may be liable for a fine or imprisonment if convicted of tax evasion, failure to complete a tax return or for failure to disclose all of his or her income in an income tax return²⁹¹.

Section 75 of the Act provides, *inter alia*, that any person who fails to furnish, file or submit any return or document without just cause shall be guilty of an offence and liable on conviction to a fine or imprisonment for a period of up to 24 months. Section 75A empowers the Commissioner to publish for general information the name and address and other particulars of offenders and their offences, where such a taxpayer has been convicted for failure to furnish information in terms of section 75, section 104 and other sections of the Income Tax Act. Section 104 provides that any person who, with intent to evade assessment or taxation, makes any false statement or entry in any return rendered in terms of the Act or gives any false answer to any request for information by the Commissioner or any person authorised by him shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding five years. Persons involved in illegal activities submitting a tax return would therefore be aware of the potential penalties should they neglect to disclose fully any information required by the Commissioner.

5.4.1 THE SECRECY PROVISIONS

The Income Tax Act empowers the Commissioner to report to the Commissioner of Police when he or she (the Commissioner for Inland Revenue) suspects that an offence, other

²⁸⁸ Income Tax and the Individual 2006/2007 1.

²⁸⁹ Income Tax and the Individual 2006/2007 1.

²⁹⁰ Income Tax and the Individual 2006/2007 1.

²⁹¹ Income Tax and the Individual 2006/2007 8.

than a revenue related offence, has been committed²⁹². Section 4 of the Income Tax Act provides as follows:

(1) Every person employed or engaged by the Commissioner in carrying out the provisions of this Act shall preserve and aid in preserving secrecy with regard to all that may come to his or her knowledge in the performance of his or her duties in connection with those provisions, and shall not communicate any such matter to any person whatsoever, other than the taxpayer concerned . . .

The purpose of the preservation of secrecy provisions in the Act is to encourage full disclosure and to obtain and retain the confidence of the person supplying the necessary information²⁹³.

Section 4(1B) of the Act, on the other hand, provides that the Commissioner may *ex parte* apply for an order allowing him or her to disclose to the National Commissioner of the South African Police Services information which may reveal evidence:

- (a) that an offence other than an offence in terms of the Act or any Act administered by the Commissioner or any other offence in respect of which the Commissioner is a complainant has been or may be committed, or where such information may be relevant to the investigation or prosecution of such offence in respect of which a court may impose a sentence of imprisonment exceeding five years; or
- (b) of an imminent and serious public safety or environmental risk . . .

The Act further provides in section 4(1B) that the Commissioner can also apply for such an order where public interest in the disclosure of such information outweighs any potential harm to the taxpayer concerned should such information be disclosed.

Provided that any information, document or thing provided by a taxpayer in any return or document, or obtained from a taxpayer in terms of section 74A, 74B or 74C, which

²⁹² Section 4(1B) of the Income Tax Act 58 of 1962.

²⁹³ *Union Government v Shiu* 1955 (1) SA 298 (T) 300.

is disclosed in terms of this subsection, shall not, unless a competent court otherwise directs, be admissible in any criminal proceedings against such taxpayer, to the extent that such information, document or thing constitutes an admission by such taxpayer of the commission of an offence contemplated in paragraph (a).

Although section 4(1) of the Act provides for secrecy, the Commissioner may disclose information under certain circumstances which may, if directed by a competent court, be admissible in criminal proceedings. Compliance with the requirements of the Act may render a person engaged in illegal activities vulnerable to criminal proceedings relating to the activities themselves.

Taxing fraudulently received money and stolen money, as well as income derived from prostitution, therefore has implications other than tax implications.

The income tax return to be submitted by taxpayers carrying on a business requires the taxpayer to disclose the nature of the business carried on and to select an appropriate code for the classification of the business. Under, for example, the section for retail trade, a code number is provided for a category called "other". It may not be necessary at that stage to disclose the exact nature of the income and therefore the fact that it arises from an illegal activity. The problem will arise, however, should the person be required to furnish further particulars.

Section 74A²⁹⁴ provides as follows:

Furnishing of information, documents or things by any person –

The Commissioner or any officer may, for the purposes of the administration of this Act in relation to any taxpayer, require such taxpayer or any other person to furnish such information (whether orally or in writing), documents or things as the Commissioner or such officer may require.

²⁹⁴ Income Tax Act, 58 of 1962

Section 74B²⁹⁵ makes provision for obtaining the information, documents or things either by requiring the taxpayer or any other person to furnish them for the purposes of inspecting them, auditing them, examining them or obtaining them, or by visiting any person at any premises during that person's normal business hours. It is at this stage that the problem of secrecy may arise.

5.4.2 PRIVILEGE AND SELF-INCRIMINATION

In terms of the law of evidence, a privilege comes into operation in terms of which a witness is not obliged to answer a question or to supply information that is relevant to a matter before court²⁹⁶. A witness is thus said to be privileged when he or she may validly refuse to answer a question or to supply information which would be relevant to the determination of an issue in judicial proceedings²⁹⁷. The right to claim such a privilege can be waived²⁹⁸.

The privilege against self incrimination prohibits a person from being compelled to give evidence that incriminates him or her²⁹⁹. It operates as a shield against an obligation of compulsory disclosure³⁰⁰. Taxpayers are not informed of this shield when they are completing tax returns and some taxpayers may end up disclosing income that the Commissioner may suspect was obtained from illegal activities and this information may then be used to build a criminal case against such taxpayer. In other words, a taxpayer may incriminate himself or herself in a tax return and such information may be made available to the South African Police to aid them in their investigations. An investigatory mechanism may not, however, be used to build up a case against the examinee, by forcing him or her to speak and disclose information which is then used to find more evidence

²⁹⁵ Income Tax Act, 58 of 1962

²⁹⁶ Schwikard *Principles of evidence* 2 ed (2002) 115.

²⁹⁷ Tapper *Cross and Taper on evidence* 9 ed (1999) 420.

²⁹⁸ Schwikard *Principles of evidence* 2 ed (2002) 116.

²⁹⁹ *R v Comane* 1925 AD 570 575.

³⁰⁰ Tapper *Cross and Taper on evidence* 9th ed (1999) 424.

against such person³⁰¹. The rationale for the right not to give self-incriminating evidence is to encourage accused persons to testify freely³⁰². A taxpayer would, however, not readily refuse to answer questions in a tax return, because of the consequences of failure to do so, of which a taxpayer is informed.

The privilege against self incrimination is a common law principle but it is now constitutionally protected. The Constitution provides that an accused, detained and arrested person has a right not to be compelled to make a confession or to give self-incriminating evidence. In *S v Lottering*³⁰³, a case decided after the coming into operation of the Constitution, the accused made an admission without being warned of his constitutional right to remain silent and the right to legal representation. The court held that as there were no threats or intimidation and no force used, he acted voluntarily³⁰⁴. It is submitted that a taxpayer does not act voluntarily when filling in a tax return, taking into account the fact that the Commissioner is empowered to publish names of offenders and that failure to complete a tax return fully and honestly may result in a conviction and imposition of fines or imprisonment.

A taxpayer has no one to advise him or her of the consequences of answering or not answering a question on a tax return or responding to a request for information by the Commissioner and, because of this, taxpayers may incriminate themselves.

5.4.3 CONSEQUENCES OF FAILURE TO INFORM A PERSON OF HIS OR HER CONSTITUTIONAL RIGHTS

The Constitution introduced section 35(5), which provides that evidence obtained in a manner that violates any right in the Bill of Rights must be excluded if the admission of such evidence would render the trial unfair or would be detrimental to the administration

³⁰¹ Brucwe "A duty to answer questions? The Police, the Independent Complaints Directorate and the right to remain silent" (2000) 16 (1) SAJHR 71.

³⁰² Schwikard *Principles of evidence* 2 ed (2002) 117.

³⁰³ *S v Lottering* 1999 12 BCLR 1478.

³⁰⁴ *S v Lotterind* 1483 E.

of justice process. The presence or absence of prejudice to the accused as well as the nature and degree thereof, has an impact on the question of whether or not to exclude the evidence in the interests of ensuring a fair trial³⁰⁵. It is submitted that the disclosures required of taxpayers earning income from illegal activities would be extremely prejudicial and that such evidence should be inadmissible against an accused taxpayer. The evidence is obtained under duress and the taxpayer is not warned of the right to remain silent – that is, taxpayers are not warned of the potential use of such disclosures as evidence in a criminal trial.

The Constitutional Court, in *Bernstein v Bester NO*³⁰⁶, held that evidence obtained under compulsion may not be used in subsequent civil proceedings against a person. South African law recognises two factors that can affect the voluntariness of an admission: they are a threat or a promise from a person in authority. A liberal meaning of a person in authority was given in *S v Robertson en andere*³⁰⁷ where it was held that a person in authority is anyone who exercises a degree of authority over the accused, whether or not she or he occupies an official position. This interpretation is wide enough to include the Commissioner for the South African Revenue Services or a duly appointed official.

When criminals in the United States were charged with revenue crimes, including tax evasion and failure to file a tax return, the right against giving self-incriminating information guaranteed in criminal law could not be used as a defence as a taxpayer could object to the use of such information at the stage of filing of a tax return³⁰⁸. It was assumed that if one discloses information in the tax return without objecting to it being utilised to formulate a subsequent criminal case, that such information was supplied voluntarily³⁰⁹. In other words when it came to disclosing income the right not to incriminate oneself did not apply if the taxpayer did not lodge an objection to subsequent

³⁰⁵ *S v Soci* 1998 (2) SACR 275 (E) 293-294.

³⁰⁶ *Bernstein v Bester NO* 1996 (4) BCLR 449 (CC); 1996 (2) SA 751 (CC) paras 107-123. .

³⁰⁷ *S v Robertson en andere* 1981 (1) SA 460 (A).

³⁰⁸ *United States v Sullivan* 177 F.ad 607, 617-18 (9th Cir. 1940) at 263

³⁰⁹ *United States v Sullivan* 177 F.ad 607, 617-18 (9th Cir. 1940)

use of such information. The case of *Garner v United States*³¹⁰ brought about a change in the treatment of information disclosed in a tax return with regard to subsequent non-tax prosecutions. The taxpayer in *Garner v United States* was a gambler and he disclosed this fact in his income tax return and he was prosecuted for contravening gambling laws. The court held that admitting in his tax return that he was a gambler amounted to self-incrimination and affected his privilege against compulsory self-incrimination. It was further held that the taxpayer was not effectively given the opportunity to assert his privilege either by not filing a tax return or refusing to supply the incriminating information and that he was entitled to use his right with regard to non-tax prosecution. It was further held in *Garner v United States* that for taxpayers to effectively waive a privilege they must be aware of its existence and waive it voluntarily and knowing the implications of such a waiver. The rationale for requiring a taxpayer to honestly fill in a tax return is based on the fact that revenue laws are not intended to tax income from legal sources only, but to tax all income derived by the taxpayer³¹¹.

5.5 CONCLUSION

To a layman, the taxation of income from illegal activities may appear to be unethical and it may also appear that the Revenue authorities or government are condoning and benefiting from crime³¹². This taboo on the government taxing income from illegal activities stems from the fact that some people do not believe that it is possible to extract legal tax from illegal income. By contrast, one writer has given the title 'money does not smell' to her article and it is submitted that this is based on the view that South African tax law is rightfully claiming what is due to the *fiscus*. The notion of government benefiting from crime is inevitable. In addition, Value-Added Tax is levied on most goods and services provided in South Africa and the source of the money used to pay the Value-Added Tax is not relevant.

³¹⁰ *Garner v United States* 71-1219 (9th Cir., June 5, 1972)

³¹¹ 1973. 'Constitutional Law. Self-Incrimination. Use of Information Provided without Objection on Income Tax Return Prohibited in Prosecution for Nontax Offence. *Garner v. United States*, No. 71-1219 (9th Cir., June 5, 1972)', *Harvard Law Review*, 86 (5): 914-922 at 916

³¹² T.H.B. Jr. "Income Tax Consequences of theft" (1949) 25(6) *Virginia Law Review* 759-773759

To summarise, South Africa needs funds to finance the government's budget. In terms of South African law income, regardless of its nature, is taxable. If criminals are taxed they are contributing their share to the *fiscus* and, if they are not taxed, this appears to be condoning criminal activities. The disallowance of deductions on the basis of the expenditure not being incurred in the production of (illegal) income leads to an unjustifiable differential treatment of taxpayers. There are other ways of punishing wrongdoers and tax laws should put all income on an equal footing and not differentiate between taxpayers when it comes to allowing deductions. Government agencies are tasked with different duties, but they work hand in hand in order to achieve the same goal of a better society for all. If the Commissioner for the South African Revenue Services does not disclose the information about suspected crimes then the law enforcement branch suffers and the Commissioner would appear to be assisting criminals to avoid justice. If the Commissioner discloses such information, on the other hand, a taxpayer is prejudiced and his or her constitutional rights may be infringed.

It appears that court decisions have provided certainty regarding the taxation of income derived from illegal activities. The question of the deductibility of expenses incurred in producing this income also appears to be fairly certain. A grey area, however, is the deductibility of compensation or restitution that the criminal would have to make, if his or her crime is discovered.

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